Fundamentals of the FUTURES MARKET

- Margins: Initial, Maintenance, and Call
- Major Indicators to Follow to Improve Trades
- Key Terms and Definitions

DONNA KLINE

Find Out How Any Investor Can Hedge Portfolio Risks—and Increase Trading Profits—in Today's Futures Marketplace

The futures market—long seen as the province of professional hedge fund managers and frenzied, hand-waving pit traders—has begun to grab the attention of individuals everywhere. Sharp investors are using today's technology to access high-level research and information, hedge their trading risks, and leverage small amounts of cash into sizable investment profits.

Fundamentals of the Futures Market is a step-by-step guidebook to the opportunities and risks in today's wide-open futures markets. Plain-English analyses and explanations combine with quizzes, checklists, charts, graphs, and more to reveal:

- Reports and major indicators to watch—and how to interpret their meanings
- Types of orders—including market, limit, and stop orders—and when to use each
- **Tips of the Trade**—Techniques the pros use to profit from price changes, avoid errors, and more

From hands-on basics to advanced technical skills, *Fundamentals of the Futures Market* will give you everything you need to truly understand and profit from the exciting, newly accessible futures marketplace. Let this hands-on book—along with its companion *Fundamentals of...* investing guides—help you build the skills and confidence for success ... *before* you risk your money in the no-room-for-error waters of real-time trading!

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This book is printed on acid-free paper.

Dedication

This book is dedicated to all of the futures and options traders I have had the opportunity to work with over the years. Throughout all of our trials and tribulations, each and every one of you has, in some way, had an extraordinarily positive influence on my life, both personally and professionally. I will always cherish our relationship and wish you the very best in *every* new venture.

Contents

Preface

This book is designed to provide you with the necessary tools to begin futures trading. There is no Holy Grail, I assure you, but at least you now have a place to start that will hopefully *clarify* some of the issues involved with trading the markets.

All things are subject to change. As with any growing marketplace, technological advances and new regulations can change the trading environment. You must be flexible and keep yourself informed as to these changes. A good broker, industry colleagues, and information direct from Exchanges or Government publications can help you to stay enlightened.

This book has been written to dispel trading myths, to reveal the nuances of certain market actions, and to prevent you from making the same mistakes as most beginners in the futures industry. I have compiled all that I have learned over my career as a broker from contract specifications and order entry, to client relationships and market analysis. I truly hope that you learn something new by reading this book. I have also designed it to be a reference guide, so that you may refer to it often to answer any questions that come up along the way.

Learning to trade is a journey, a path with many turns and divots. As with life in general, each detour becomes a learning experience—each milestone a new victory. Tread carefully, so that despite any bumps in the road, you are still able to continue onward, toward your financial goals.

Best of luck with your journey.

Donna Kline
September 19, 2000

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Chapter 1

Origins: The Markets and Their Beginnings

Introduction

The futures markets have lured investors for many years. Like moths to a flame, curious traders are drawn to the excitement, the opportunity, and the heat of the battle. The markets burn many traders, however, because the prospect becomes a greater challenge than it first appears. But that will not keep us from trying. The futures markets are extremely attractive ventures where fortunes are made and lost in a single day, and where images of frantic pit traders market hysteria and extraordinary financial returns in our heads.

Money, power, and fortunes are the motivators, but it takes more than a dream to survive in the futures business. Survival depends on education and discipline. The futures markets offer a tremendous opportunity for profit, and you must be consistent, yet flexible to changes in the marketplace. You must also adapt to your own *internal* changes as you develop your skills as a trader. You will find, over time, which methods work the best for you.

Speculators in the futures markets provide an essential function: the assumption of risk. In exchange for the assumption of risk speculators are afforded the potential for enormous returns. These risks are associated with the production of goods and services and have *always* been present in the market place. For example, an entrepreneur faces a tremendous amount of risk to finance and market his or her invention or business. By giving partial ownership of the business to a financier who is willing to assume the risk of production and marketing, the entrepreneur is more likely to pursue the idea. Similarly, with futures, a farmer has a price risk during the time between the planting and marketing phases of a crop cycle, and the futures markets provide a vehicle for the transfer of that risk. Speculators provide the liquidity that helps make the futures markets efficient.

Futures markets exist only in relation to the underlying spot market for grains, currencies, stock indices, or bonds. The supply and demand (and consequently, the price movement) in the cash market determines the price of a futures contract. Without a flow of trade in the underlying contract, the futures contract does not exist.

Historical Development of the Futures Markets

The commodities markets have a fascinating development story. They were not always the powerful and efficient markets that we know today; rather, they had to grow and mature over time. As the modern economy continues to expand, better rules and newer contracts will develop in order to meet the needs of a changing world.

> *If we did not already have futures, we would have to invent them.*
> —Tony Freeland, grain merchandiser, as quoted in *The Commodity Trading Manual* (published by the Chicago Board of Trade)

The history of the futures markets began in the Midwest during the early 1800s, when society was simple and rural and Chicago was a newly incorporated city of only 4,000 residents. The region was growing quickly due to the development of agricultural trade. Chicago was located along Lake Michigan and had easy access to the Mississippi River, making it an ideal location for agricultural trade. The industry was new, however, and suffered many imbalances of supply and demand. The business dealings were rough and not regulated.

Agriculture, for the most part, is a seasonal industry. Grains are typically sown in the spring and harvested in the fall. In the 1800s, this fact created extreme supply and demand imbalances throughout the year. During the fall, when supplies were plentiful, prices of grain products were extremely depressed. Millers had an abundance of new crops from which to choose and would pay the lowest price they could. In fact, many farmers were left with cartloads of unsold grain that they were not willing to haul back to the farm. Sometimes, the product was left on the road to rot.

Then, there were the lean times. During a long, cold winter, supplies dwindled, prices soared, and many people (and cattle) went hungry. Even if it seemed there was a glut of supply in the fall, winter would wreak havoc on the industry. Not only were supplies tight, but incomes were tight, as well. Farmers had a difficult time maintaining a steady cash flow during the off season. Many farmers and millers faced bankruptcy. In order for the region to survive, changes were necessary.

Forward contracts began to emerge. A forward contract is an agreement between a buyer and a seller on a price, quality and quantity, and a future delivery date for a commodity. Nothing about the contract is standardized; thus, each contract has terms and conditions that are negotiated between the buyer and the seller.

For example, merchants would buy corn from farmers in the fall and would then need to store it for delivery to processors in the spring. During the time between purchase and delivery, the merchant was suspect to volatile swings in price. In order to protect themselves from this risk, merchants would travel to Chicago and arrange a deal with the processors for delivery at a later date. The first forward contract on record was made on March 13, 1851. The contract was for 3,000 bushels of corn to be delivered in June at a price of one cent per bushel below the price of corn on March 13. They traded these forward contracts in a room above a flour store, and that room was the first official location of the *Chicago Board of Trade* (CBOT).

Forward contracts had their drawbacks, however, because they were not standardized according to delivery time or quality. Because they were agreements between two parties, there were times that traders did not see the need to fulfill their contracts if market conditions did not warrant a profitable transaction.

To solve this problem, the CBOT agreed to give more structure to the contracts and began to shape the modern futures contract that we know today. The futures contracts were standardized according to quality, quantity, and time and place of delivery for the commodity traded. In addition, participants were required to post a margin deposit in order to eliminate

the problem of default. A certain percentage of the contract value had to be on deposit at the exchange.

Other critical steps in the development of futures contracts helped them become more efficient. Harvesting and transportation conditions determined the months for delivery of grain products. Weather was an issue in the Midwest, and the months for delivery were based on that fact. They chose March because it was the first month after winter that travel conditions improved. May was a good time to clean out stored grain and get ready for new grain that workers harvested in the summer and fall. December was the last month that farmers could successfully deliver grain before the winter began and consequently became the official delivery month of new crops, wherein the contract consisted entirely of a freshly harvested product.

Probably the most important evolution in futures trading was the emergence of the speculator. As these contracts became more standardized, individual business professionals began to speculate on the price fluctuations of these contracts—trading them for the short term. Speculators would buy a contract of corn in the hopes of selling it back at a later date for a profit, although they had no intention of making or taking a delivery. The advantage that speculators bring to the futures markets is liquidity. Liquid markets usually do not have erratic price movements. Speculators helped stabilize the futures markets.

Financial Futures

As the United States moved away from an agrarian economy and into an industrial and ultimately technical age, futures contracts also grew and diversified. An important revolution was the modernization of the financial markets.

There was a tremendous amount of interest rate uncertainty in the 1970s. This situation came about in part due to the elimination of the Gold Standard in 1971. Previously, the dollar had been convertible into fixed amounts of gold, but after 1971, the elimination of the Gold Standard enabled the dollar to float against the values of other currencies. This standard increased the price risk involved with importing and exporting. Exchange-rate volatility also led to interest-rate volatility.

Paul Volcker, chairman of the Federal Reserve Board in 1979, shifted the focus of monetary policy away from interest rates and toward money supply. Free from federal control, this action accentuated the fluctuations in interest rates.

The United States also issued a tremendous amount of debt during that time period. With the new change in monetary policy, the risks of being a bond holder increased. Gone were the days when a government bond was a stable investment.

With the volatility of interest rates and exchange rates came volatility in the export markets. No market was as adversely affected as the energy market. During 1973, an oil embargo drove the price of crude oil through the roof. You might remember the long lines at the gasoline pumps. This type of volatile price environment took heavy tolls on the fi-

nancial health of individual companies. These companies relied on stable raw materials costs in order to be profitable. Ideally, as with the farmers, there would be a place for companies to hedge this type of risk exposure: futures markets.

Answering the call, the CBOT and *Chicago Mercantile Exchange* (CME) developed contracts designed to hedge against currency and interest-rate exposure.

At the CME in 1972, contracts began trading on the British pound, Canadian dollar, German Deutsche mark, Japanese yen, and Swiss franc. These contracts were a great advantage to anyone involved in importing and exporting goods across international lines. If a U. S. firm was contracted to deliver two truckloads of audio equipment to London, England, and upon delivery was to be paid in British pounds, the firm had the risk that the value of the British pound would decline versus the U. S. dollar during the time of manufacturing and delivery. In order to lock in an exchange rate, the firm would sell a British pound futures contract and buy it back upon payment. That way, if the value of the British pound declined, the firm would be profitable on the futures contract and would make up for the loss due to the exchange rate. If the value of the British pound increased during that time, the firm would lose money on the futures contract but make up for it due to the increased value of payment upon delivery.

The CBOT introduced mortgage rate futures. The futures contracts were based on the interest rate charged for long-term mortgages. The futures were called "Ginnie Mae" and were based on the Government National Mortgage Association mortgage-backed certificates. Anyone who participated in mortgage loans could now use these contracts to hedge against the volatile interest rate environment.

Probably the greatest introduction to modern futures trading was the *Treasury Bond* (T-bond) futures contract. This contract tracked the interest rate available on 30-year Treasury bonds, which in turn fluctuated with the overnight lending rate. Investors who held large amounts of treasury bonds in their portfolios could use the T-bond futures contract to hedge financial vulnerability to interest-rate fluctuations.

Once traders discovered the potential for financial futures, many more contracts developed in order to hedge against all kinds of different risk exposures (shorter-term treasury notes, 30-day lending rates and stock indexes, Eurodollar deposits, and so on).

Options

The next major development in modern futures markets was the creation of the options markets. Options trading first gained popularity at the Chicago Board of Options Exchange. This exchange focused primarily on individually traded stocks. An option buyer had the right to buy or sell a stock at a specified price at any time during the life of an option. If conditions were not favorable, the buyer of the option could simply let the option expire and risk only the price paid for the option. By 1982, options began trading on T-bond futures, and the growth of the product was

tremendous. Traded in the open outcry format, the options market provided many more speculating and hedging vehicles for the trading public. The success of the options contract opened the doors for the introduction of options on many other commodity products, including corn, soybeans, and other products.

Modern Developments

As society continued to modernize, other countries began to realize the importance of futures contracts to economic stability. Exchanges began trading in Britain, Brazil, Germany, France, Tokyo, Singapore, Hong Kong, and Australia.

The globalization of world markets created the need for links between foreign exchanges. As the world became a more synergistic society, the need for electronic links and 24-hour trading developed. The U. S. futures exchanges did their part to meet this demand by creating international products, expanding trading hours, and creating an electronic marketplace.

The most noteworthy developments were the GLOBEX system (developed by the CME) and the Project A system (developed by the CBOT). In Germany, the Deutsche Terminborse Exchange eliminated open-outcry trading altogether and now strictly operates as an electronic marketplace.

On the GLOBEX exchange, individuals can trade the SP500 and mini-SP500 and the NASDAQ 100 futures index and its miniature contract. Individuals can trade currencies on GLOBEX, as well.

On Project A (now Eurex)*, individuals can trade T-bonds and notes, options, and all of the grain products traded at the CBOT. Electronic trading is designed to support open outcry by providing an additional outlet for trading after market hours.

As society has become more modern, so have the financial markets. Access to information boosted by technology, mathematical efficiencies with respect to trading, and the globalization of world economies has led to the financial revolution that we are experiencing today. The futures industry will continue to grow and adapt to the needs of an evolving financial world.

Open Outcry and the Pits

While it might appear as utter chaos, open outcry is an extraordinarily efficient means of price discovery. A futures exchange provides a location for buyers and sellers to meet and bid for the best-available price. Transactions occur between floor officials, either those who are trading

* In August 2000 the CBOT launched an alliance with electronic european exchange called EUREX, all trading on Project A now on Eurex.

for their own accounts or brokers who are facilitating trade between floor traders and phone orders called in to the exchange.

Only exchange members can trade on the floor—a privilege that does not come cheaply. Members must purchase this right by buying a seat at the specific exchange. The value of memberships fluctuates like a normal market, but the price of a seat has steadily risen over many years. In some instances, such as the *New York Stock Exchange* (NYSE), the price of membership exceeds $1 million.

The reason why memberships have such a hefty price tag is because being a member of an exchange gives the individual a great advantage in terms of commission costs and arbitrage opportunity. Seats are also available through leasing arrangements, where individuals can rent the right to use a seat from the person or firm who owns that seat. Membership, as you can imagine, has proven to be a great investment in itself—a piece of property that has increased in value over time and that grants the opportunity for steady income. Seat leases vary in price, depending on the exchange and demand at the time.

Open outcry occurs in pits, which exist throughout the floor of the exchange. Pits look just like their name implies. They are sunken, polygonal rings that have steps that descend into the center. Sometimes, the pits are raised so that the middle of the pit is at ground level, and you have to climb stairs to enter them. Pits vary in size depending on the volume traded within them. As a contract expands in popularity, more people want to be inside the pit—and exchanges often must build larger ones in order to accommodate the increased participation.

Various pits are scattered around the trading floor, and on the perimeter of the area are many trading desks. They are designed to facilitate telephone calls from the outside and communicate orders into the pits. They are stacked on top of each other like bleacher stands. Behind all of the desks, along the walls, are price boards that update the recent trading price for every futures and options contract traded on that exchange, as well as the prices of futures contracts traded elsewhere. Also on the price boards are scrolling news wires that update recent reports and important market information. In the agricultural centers, there are also large televisions that update the weather conditions around the world.

When an order is called into the exchange, the trading desk takes the order, time stamps it, and gets the message to the pit. Someone either flashes the order into the pit via a hand signal, or a floor clerk (often called a runner) runs the order into the pits. Surrounding the perimeter of the pits are *arbitrage* (arb.) clerks who take the tickets or accept the hand signals that come from the surrounding trading desks. Arb. clerks then communicate the orders to filling brokers inside the pit. The broker then executes the trade either with another broker or a trader, makes note of the transaction, and then returns the transaction result to the trade desk either via hand signal (arb. clerk) or by a runner. The individual then time stamps the order again and reports it to the customer. Almost all phone lines on the trading floor are recorded for accuracy and protection.

Every trade that occurs on the floor is posted on the price boards overhead. There are special exchange employees who record every transaction that occurs in the pit. They are positioned either in high chairs on the side

of the pit (like a lifeguard) or inside the pit itself. They record every transaction by punching the trade into a computer, which then conveys the price on the boards. At the same time, the trade price is sent electronically via various vendors who then transmit the data to their many thousands of customers.

Floor Brokers and Traders

Floor brokers fill incoming price orders. Commission houses employ some of them to fill their clients' orders, while others are independent and make a living by filling orders from a variety of sources.

Locals trade their own accounts and speculate on futures price movements. There are position traders, day traders, and scalpers. Position traders hold open positions for days or weeks. Day traders might hold a long or short position but exit by the end of the trading day. Scalpers are in and out of trades many times throughout the day, hoping only to profit from the smallest increment in price. Locals provide liquidity to the marketplace.

Floor brokers and locals often employ the clerks, runners, and arb. clerks on the floor to help them facilitate communication and to check out trades with other members.

In open outcry, communication is the key to a successful and efficient marketplace. In open outcry, individuals shout all bids and offers out loud in the open, so that every participant in the pit has an equal opportunity to transact.

To support the verbal indication, traders also developed hand signals to decrease the likelihood of misunderstanding (see Figure 1-1). Hand signals vary among exchanges but have many things in common. Hands stretched out, with palms facing the crowd, are an indication to sell. Hands up and palms faced in are an indication to buy. Various fingers signify various digits, as well. For example, the usual one, two, three, four, and five are as we know it, but higher than five, the signal changes. To make a six, you extend your index finger and tilt your hand to the side. A seven is two fingers extended with the hand tilted to the side, and so on. Whenever someone gives a signal in relation to your face, this action also has meaning. Signals given up by your forehead signify blocks of 10. Therefore, a number two given from your forehead is 20. If you touch your chin with a two-sign after you touch your forehead, the number is 22. Each digit has different meaning inside different pits.

Another common element to a hand signal is the order in which the person gives the signal. If a trader wishes to buy something, the trader quotes the price that he or she is willing to pay and then the quantity that he or she wishes to buy (for example, "I'll pay 6 for 20"). To sell, he or she indicates the quantity and then the price (for example, "I'll sell 20 at 6").

Each time a trade occurs, the participating parties make note of the transaction on a trading card (or in some cases, into a hand-held computer). The purpose is to have a recorded document of each transaction. Traders have a financial responsibility for every transaction that they make, and their accounts are marked to the market at the end of each day. Sometimes, a mismatch of orders occurs (called an out trade). For example, one trader thought that he bought five when the other trader

Figure 1-1 *Common hand signals in market trading. Source:* Commodity Trading Manual, *CBOT.*

thought that he sold 15. This situation happens at times, and the exchange rectifies the problem in an orderly fashion.

Although it might look like chaos, a certain code of ethics exists on the trading floor. Although floor traders are aggressive, the perception that they are thieves is not always true. While some traders have a bad reputation, most participants are career minded and do not risk their jobs and membership by being unethical. Being ethical and taking advantage of your membership are two different things, however. By being a member in the trading pits, you have the right to make a market for any trading vehicle. In other words, you can set the bid or offer a price at any level within reason. This advantage justifies the high cost of a trading seat and is called the edge.

Who Trades Futures, and Why?

There are essentially three classes of participants in the futures markets: hedgers, large speculators, and small speculators.

Hedgers. Hedgers, or commercial traders, are the firms and individuals involved in the cash trade of the business. Hedgers include farmers, stock portfolio managers, importer/exporters, and jewelers. Each of these businesses involves a price risk. Farmers need to protect themselves from price fluctuations in the grain markets. Portfolio managers need to protect their risk in the equity markets. Importer/exporters need to protect themselves from currency fluctuations that occur between the time that they make a sale and the time that they are paid for the delivery of goods. Jewelers might use the commodity markets to hedge against the rise and fall of the price of gold or platinum.

The futures markets provide an opportunity for the hedger to establish a price for the product in advance of delivery. For example, a jeweler who needs to buy gold in the future can protect himself/herself against a rise in gold prices by buying a gold futures contract today that has a delivery time in the future. If gold prices rise, the hedger will profit from the gain in the futures price—which will offset the need to pay a higher price for gold on the cash market.

The hedger will generally not make or take delivery of the futures market position. In fact, fewer than two percent of all futures positions are actually delivered. More often than not, the futures position is liquidated at some time prior to expiration.

Example: Hedging Gold. If a jeweler needs to buy gold in the open cash market every quarter, he or she might want to use the futures market to offset the advent of higher prices:

Month is October.

Current price of gold bullion is $245 per ounce.

Jeweler needs to buy 100 ounces of gold in December.

Jeweler buys one December gold futures contract at $245 per ounce; each contract represents 100 ounces.

Gold rises $10 per ounce into December.

Hedger sells December futures contract at $255 (makes $10 per ounce, or $1,000).

Hedger buys gold on open market at $255 per ounce.

Although the hedger had to pay more for the gold, the profit made on the futures position helped offset this price risk.

What If the Price of Gold Goes Down?

Month is October.

Current price of gold bullion is $245 per ounce.

Jeweler needs to buy 100 ounces of gold in December.

Jeweler buys one December gold futures contract at $245 per ounce.

Gold falls $10 per ounce into December.

Hedger sells December futures contract at $235 (loses $10 per ounce, or $1,000).

Hedger buys gold on open market at $235 per ounce.

Although the hedger got to pay a lesser amount for the gold, the loss on the futures position helped offset this price advantage.

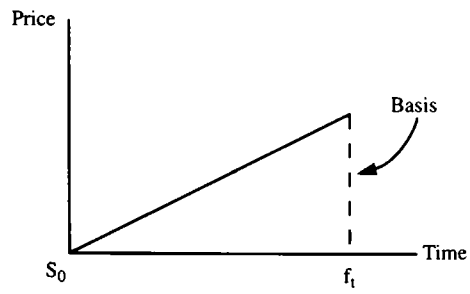
NOTE

There is something in futures pricing called the basis. The basis is the difference in the cash price and the futures price. Hedging is not a perfect science. What that means is that there are several influences that hinder the ability to create a perfect dollar for dollar hedge. Such influences include seasonal factors, commissions, opportunity costs (interest rates), and slightly different fill prices.

Basis = Futures Price − Cash Price

More often than not, there is a positive basis in the futures markets. The futures price usually trades at a higher price than the cash price (refer to the previous note). This positive basis reflects the time until delivery, the cost of storing the commodity, and current interest rates. Using gold as an example, the cash market might be at $245 in October, but the December futures might be trading at $255. This premium in price above the spot price reflects the cost of carry, or positive basis (refer to Figure 1-2). As time passes and delivery approaches, the cost of carry nears zero. Thus, the futures price converges to the spot price as delivery time approaches. Basis can also change daily as local cash prices fluctuate. Due to market volatility and a shrinking basis, there is never really perfect hedge.

Figure 1-2 *Basis*



S_0 = spot price

f_t = Futures price at time t

Futures price converges to spot price as time approaches delivery

NOTE

There are two instances when the cost of carry does not near zero: 1) in an inverted market, which is driven by short-term supply constraints or extreme neoterm demand (energy markets are often inverted), and 2) in interest rate products, where normal market conditions show prices lower in the future (the interest rate is higher, and interest rates move inversely to price).

Large Speculator. A large speculator is usually a fund manager who uses the futures markets purely for speculative purposes. The large speculator does not usually participate in the cash market and makes his or her profits strictly from price movement in the futures markets. Because the fund manager manages large amounts of money, his or her positions are usually quite large. Many traders pay attention to what the fund managers do in order to gain an idea of future price movement. Examples of large speculative funds are those that *Commodity Trading Advisors* (CTAs) or *Commodity Pool Operators* (CPOs) trade.

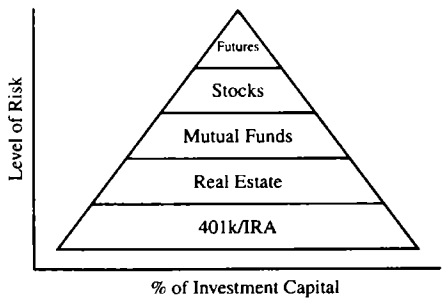
Small Speculator. Small speculators make up most of the trading volume in the business. Small speculators include doctors, lawyers, dentists, and engineers. They can be students, housewives, or physical therapists. The jobs are not the same, and the incomes are not the same, either. The one thing that small speculators have in common is the desire for leverage.

Futures trading is inherently risky, but with that risk comes the great opportunity to profit. With futures trading, you can leverage a relatively small amount of money to make a large amount of money. The leverage draws the speculator into the market.

Because futures trading is a risky investment, you should conduct all trading with risk capital. Do not trade with borrowed money, college savings, or income required for survival.

In fact, when you look at the investment pyramid, you should only conduct futures and options trading with your riskiest of capital (refer to Figure 1-3). We do not recommend that you *ever* trade with more than 25

Figure 1-3 *Investment pyramid*



percent of your total liquid savings. (Liquid means cash, stocks, mutual funds, and so on.) This savings does not include IRAs, 401K, or real-estate investments.

Quiz

1. People are drawn to the futures market due to the safety of the investment. (true or false)
2. Most futures participants take delivery of the commodity. (true or false)
3. What is the primary purpose of the futures markets?
4. A futures contract is a binding agreement. (true or false)
5. What is the definition of *basis*?
6. What market would an importer/exporter of Japanese stereos use to hedge currency exposure?
7. Floor traders make their livings by stealing money from market participants. (true or false)

Answers

1. False. People are drawn to the futures market for the leverage that it can provide. People also have a fascination with the wealth and power that assumedly is associated with the futures market. Many people trade commodities more for the excitement than for the profit.
2. False. People use modern futures markets as a hedge against price fluctuations, not as a means of establishing a delivery transaction. Most of the volume in the futures pits is purely speculation, because traders hope to profit from the rise and fall of prices without any participation in the cash commodity.
3. The primary purpose of the futures market is to hedge price exposure between buyers and sellers of commodity items. The introduction of the speculator provided liquidity and transferred some of the risk away from the hedgers.
4. True. Unlike a forward contract, which traders negotiate on an individual basis, a futures contract is a binding agreement. The exchange sets the terms of the agreement (for example, time of delivery, size of contract, and grade of quality).
5. Basis is the difference between the futures price and the spot price (also called the cost of carry). The cost of carry approaches zero as we get closer to the date of delivery.
6. An importer of Japanese equipment has to buy the goods in Japan. Most likely, the person must make the purchase in Japanese yen. The importer has the risk that the value of the dollar will fall against

the yen, making the relative value of the purchase more expensive. To protect against a rise in the yen, an importer would buy Japanese yen futures contracts.

7. False. This question reveals a common misconception. While being on the floor has its advantages, a floor trader makes his or her money by making profitable trades. A floor trader has just as much chance (or even more of a chance due to the larger trading volume) to lose money in the markets as the rest of us. A floor trader has to learn and relearn the lessons of discipline in order to be successful, just like anyone else.

Futures Trading: Is It Speculation or Gambling?

Many people cringe when they hear the word commodities. Bring up the subject of futures trading at a cocktail party, and watch people explode with comments such as, "That's sheer craziness!", "Why don't you just give me your money? Everyone loses when they trade commodities," or "Why don't you just take a nice long trip to Vegas?" The popular opinion is that futures trading is no different than high-stakes gambling.

The primary difference between speculating in futures and gambling is that the futures markets would exist whether or not people chose to speculate in them. Gambling, on the other hand, would not. Futures markets serve an important economic function by providing a vehicle for farmers and merchants to hedge their price exposure. The existence of this marketplace provides a vehicle for speculators to profit. The presence of speculators, in turn, aids the merchants by diffusing some of the price volatility and risk. Together, the hedgers and speculators provide a liquid and efficient market.

Gambling, on the other hand, is an artificial industry supported by speculation alone. If there were no racetracks or casinos, gambling would not exist. There is no specific economic function of gambling. Money changes hands but does not add economic value. You could argue that the presence of casinos has helped local communities by creating new jobs and drawing tourists, but the actual function of gambling itself does not have an economic function.

The Futures Markets and Exchanges

People now trade futures contracts all over the world. The United States is still the primary market, but exchanges in Brazil and London are rapidly increasing in popularity and volume. The following list shows the major futures exchanges by region. Keep in mind that exchanges are created and merge or change names over time, so always be on the lookout for changes.

North America

CFE	Cantor Financial Futures Exchange	United States
CBOT	Chicago Board of Trade	United States
CME	Chicago Mercantile Exchange	United States
COMEX	Division of NYMEX Commodity Exchange, Inc.	United States
CSCE	Coffee, Sugar, and Cocoa Exchange	United States
CTN	Cotton Exchange	United States
FINEX	Financial Instrument Exchange	United States
KCBOT	Kansas City Board of Trade	United States
MCE	Mid-America Commodity Exchange	United States
MDX	Mercado Mexicano de Derivados	Mexico
MGE	Minneapolis Grain Exchange	United States
MSE	Montreal Exchange	Canada
NYF	New York Futures Exchange	United States
NYMEX	New York Mercantile Exchange	United States
WCE	Winnipeg Commodities Exchange	Canada

South America

BM&F	Bolsa de Mercardorias & Futures	Brazil

Europe

ADE	Athens Derivative Exchange	Greece
AFO	Austrian Futures and Options Exchange	Austria
BDP	Bolsa de Derivados de Porto	Portugal
BELFOX	Belgian Futures and Options Exchange	Belgium
EOE	European Options Exchange	
EUX	Eurex Deutschland	Germany
EUZ	Eurex Zurich	Switzerland
FOX	London Futures and Options Exchange	England
FFMA	Financial Futures Market Amsterdam	Netherlands
FUTOP	Guarantee Fund Danish Options and Futures	Denmark
IPE	International Petroleum Exchange	
LCE	London Commodity Division of LIFFE	London
LIF	LIFFE	London
LMF	London Metal Exchange	London

Pacific Rim

HKG	Hong Kong Futures Exchange	Hong Kong
KFE	Korea Futures Exchange	Korea
SGX	Singapore Exchange	
SYC	Sidney Futures Exchange	Australia
TCM	Tokyo Commodity Exchange	Japan
TIF	Tokyo International Futures Exchange	Japan

Africa

SAF	South African Futures Exchange	South Africa

Why Trade Futures?

The answer to this question is multi-fold. People trade futures because, like the stock market, there is directional price movement. If a market does not move, it is difficult to make money by trading. Another answer to the question of why people trade futures is for the leverage. Just as you can buy stocks on margin to enhance your profit potential, you can buy futures on margin, as well. The current margin requirement for stock trading is 50 percent, and in futures trading, you can leverage as much as 97 percent of your money. You can trade a contract that is worth $100,000 with as little as $2,700 in your account. Nowhere else in a regulated-exchange traded product can you find that type of leverage. Futures contracts are liquid, as well. Barring any unforeseen market conditions, traders can be in and out of a position with relative ease.

The real reason why people trade futures contracts is to make money. Why trade the markets if there is no reward? Unfortunately, some people are involved in the markets for the excitement alone. This situation is not good, because excitement and profit do not necessarily run hand in hand. Many people get caught up in the gambling aspect of futures trading, and they ultimately treat it as such. Some people get a satisfaction from being in the markets and treat futures as a form of entertainment, not unlike a trip to Las Vegas. Others, though, use the market as a crutch. Just as there are gamblers who have a healthy attitude, there are other gamblers that have a destructive gambling habit. Futures trading can have the same captivating affect on participants, and those who are susceptible to addictive behavior might find themselves using the futures markets for similar reasons. Before you venture into futures trading, ask yourself honestly what your motivations are for trading. This question might save you a lot of emotional (and financial) pain.

The availability futures contracts, the low barriers to entry, the liquidity, and the regulation have helped the industry grow dramatically

over the past decades. As the market environment continues to grow and change, the futures industry will continue to grow in order to meet the needs of both hedgers and speculators.

Examples of Futures Trades[1,2]

Long Position in Corn during the Drought of 1975

On June 30, 1975, the December corn futures contract marked a new life-of-contract low of $2.32 per bushel. Among the bearish fundamental factors was an excellent outlook for the new crop. This situation appeared in the June 30th *United States Department of Agriculture* (USDA) crop report, indicating that farmers had planted 1.8 million more acres in corn than estimated in the March 17th planting intentions report. Up to that point, the weather had been ideal for growing conditions, but export sales were slow. The carryover inventory supply was high, and it looked as though the new crop would be abundant. With demand low and supplies high, the outlook for corn was bearish. The market prices looked poised to head lower.

Six trading days later, corn jumped 25 cents in price. The December corn contract was now trading at more than 10 percent higher at $2.58. The futures prices quickly exceeded the previous month's highs, and volume was increasing. On July 10th, the USDA reported crop estimates at 6.05 billion bushels, below the previous estimates of 6.5 to 7 billion bushels. The report indicated that farmers had planted fewer acres than previously estimated; therefore, it appeared that the supply scenario was not as ample.

Temperatures remained above normal in the second half of June and into July for the corn belt and southeastern United States. These above-normal temperatures during the critical tasseling stage for corn raised concerns that U. S. corn production could be lower than normal. There was also news that other corn-growing regions (such as the Soviet Union) were suffering from crop deterioration as well.

Considering the developing conditions, a speculator elected to buy one corn futures contract and decided to go long. At the open of trading on July 11th, the speculator bought one CBOT December corn futures contract at $2.55. The margin deposit required at the time was $1,000. To protect the trade from excessive losses, the trader placed a sell stop at $2.45. The order was an indication to the broker to sell or liquidate the position if the market traded at $2.45 or lower. Corn futures have a value of $50 per penny. A stop loss order filled at $2.45 would result in a $500 loss to the trader. ($2.55 − $2.45 = 10 cents; 10 cents × $50 = $500.) The trader placed the stop order on a Good Until Canceled basis, and that

[1] From *Speculating in Futures*, published by the Chicago Board of Trade.

[2] Some of the terms used in description may be new to you. A full glossary is located in Chapter 2 for your convenience.

way, the order would be in effect day to day until filled (executed) or physically canceled.

Later that day, corn futures prices advanced sharply, closing at $264 1/2 due to news of shipping difficulties in the Soviet Union and more reports of dry, hot-weather conditions in the corn belt and around the world. After the market close, the *Commodity Futures Trading Commission* (CFTC) released the June 30th Commitments of Trader data, which indicated that the average speculator had a large net short position. Most speculators were still short, given all of the bearish information that had been predominant a little more than a week earlier.

On Monday, July 14th, there was further buying and short covering (buying futures in order to offset a short position), and the December contract reached $2.69. At that time, the speculator had a paper profit of 14 cents per bushel, or $700. ($2.69 − $2.55 = 14 cents; 14 cents × $50 = $700.) This earning was a return of 70 percent on the initial deposit of $1,000 in four days. The speculator elected to keep the position, because the trend of the market had turned higher and the market conditions were still bullish.

The following week, the market traded mostly sideways (as high as $2.71 and as low as $2.54 1/4. On Friday, July 18th, the market closed at $2.55 1/4, only 1/4 cent higher than the initial purchase price. The paper profits appeared to be lost. Upon re-evaluation, the trader determined that the position was still sound and elected to keep it.

By the next Friday, July 25th, the contract had closed at $2.70 1/4 after posting a high for the week of $2.74 3/4. The account balance of the trader at the high price was nearly two times what he or she originally traded. To protect some of the profits, the trader decided to raise (change) the stop loss to $2.60 per bushel.

During the weekend, more news of hot, dry conditions plagued the corn crop. On Monday and Tuesday, corn traded limit up (10 cents per bushel). That put corn at $2.90 1/4 per bushel by Tuesday's close. ($2.70 1/4 + $.10 + $.10 = $2.90 1/4.) The market conditions had turned severe. Paper profits had now grown to $1,762.50 ($2.90 1/4 − $2.55 = $.35 1/4; 35 1/4 × $50 = $1,762.50). To protect the growing profits, the trader elected to move the existing sell stop up to $2.65. If the sell stop filled at $2.65, the trader would have locked in 10 cents ($500) of profit.

By August 8th, the market had advanced to $3 per bushel. On Friday, August 15th, the market closed at $3.18 3/4 after posting a high of $3.25 per bushel. The news continued to be bullish. Iowa, Nebraska, and the Soviet Union were all reporting deteriorating crop conditions due to the weather. The trader elected to move the stop loss up even further to $2.85. If filled at $2.85, the trader would lock in a 30-cent-per-bushel profit on the trade, or $1,500.

Prices continued advancing. On August 21st, the December contract traded as high as $3.30 1/4 but turned to close about four cents lower on the day. Volume on that day was extremely heavy—the heaviest since the advance began in early July. This situation was an indication that the market might turn around. The trader raised the stop loss order to the low of the week at $3.10. If the market traded at this low or lower, the trader would exit the position.

As the weather pattern began to change in the following week, prices began to fall. The trader was ultimately stopped out of the position on Wednesday at the opening price of $3.08 per bushel. By selling the contract at $3.08, the trader was able to lock in a profit of 53 cents per bushel, or $2,650. That amount is the equivalent return of 265 percent in about six weeks (refer to Figure 1-4).

Summary Table

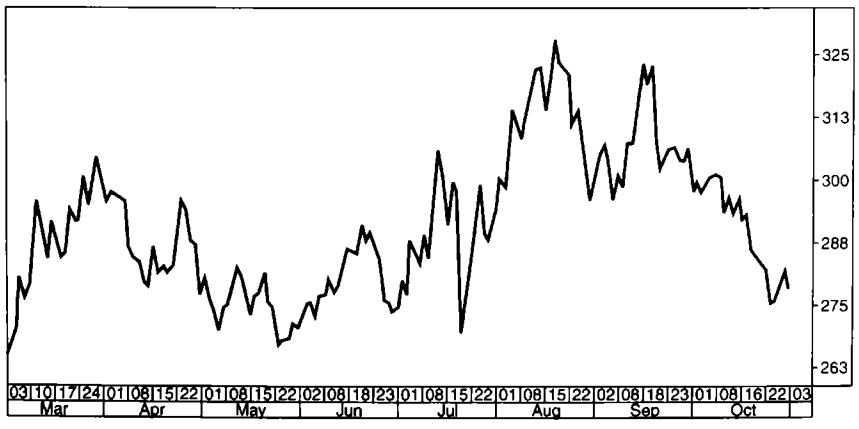
July 11th	Buys one contract at $2.55 Places sell stop at $2.45
July 25th	Raises sell stop to $2.60
July 29th	Raises sell stop to $2.65
August 15th	Raises sell stop to $2.85
August 21st	Raises sell stop to $3.10
August 27th	Sells one contract at $3.08
Net gain	$3.08 − $2.55 = 53 cents × $50 = $2,650
Percentage Gain	265 percent

Using Paper Profits to Add More Positions

The profits in this scenario could have been even greater if the trader had chosen to trade multiple positions. You do not necessarily need to add money to your account in order to trade more contracts if your position is profitable.

One advantage to futures trading is that as your position begins to accrue paper profits, you can use the additional equity to margin new positions. This procedure is sometimes called pyramiding or pillaring trades

Figure 1-4 *Corn in 1975*



*1975 Front month corn futures. (Source: *Bloomberg Professional.*)

or simply adding to your position. For example, if the corn trader mentioned previously had elected to perform this action, his or her returns could have been greatly enhanced. At the time, margin requirement for corn was $1,000. As long as the trader had $1,000 of equity per futures contract, he or she would be able to add to the initial position. In the example of corn, $1,000 is the equivalent of 20 cents. ($1,000 / $50 per cent = 20 cents.) For every 20-cent move, therefore, the trader would be able to add one more contract. If the trader had two contracts, each penny move in his or her favor would then be worth $100. Let's summarize how this action could have affected the trader's profits:

Summary Table

July 11th	Buys one contract at $2.55 Places sell stop at $2.45
July 25th	Raises sell stop to $2.60
July 29th	Market closes at $2.90 1/4
Account Balance	$2,762.50 (enough equity for two contracts) Buys one more contract at $2.90 1/4 Raises sell stop on both contracts to $2.65
August 15th	Market closes at $3.18 3/4
August 15th	Raises sell stop on both to $2.85
August 21st	Raises sell stop on both to $3.10
August 27th	Sells two contracts at $3.08
Net gain	$3.08 − $2.55 = 53 cents × $50 = $2,650 PLUS $3.08 − $2.90 1/4 = $887.50 TOTAL OF $3,537.50 out of $1,000
Percentage gain	354 percent

Many other examples exist where this type of scenario could enhance returns by many thousands of percentage points. Sometimes, advertisers will utilize the benefit of hindsight to show you how you "could have made 2000 percent on one single contract" if you had only employed their special trading method. While it is true that adding to your position can enhance profits, it is always as important to consider the down-side risk to pyramiding your trades. Just as additional positions enhance your gains as the market moves in your direction, additional positions can work against you if the market moves the other way. You must consider several important factors if you wish to attempt to pyramid your positions:

1. You have to be able to buy the market at the prices you desire. Sometimes you are not able to get a contract at the level you desire because it is moving too quickly or it is locked limit.
2. The market does not move too far against you at any time. Just as you increase the leverage potential as you add contracts, you also increase the down-side risk.

3. If the market locks limit against your position, you could quickly lose all of your profits and more. This situation involves a financial responsibility that you might not be prepared for, because you started the account with limited equity when you began.

Long Position in Treasury Bonds during the Crash of 1987

For the first three months of 1987, the bond market was relatively stable. By the end of March, however, bond prices began to fall as interest rates began to rise. Interest rates were on the rise due to several specific factors:

1. Weakness of the U. S. dollar—Widespread fear existed among investors that a weak dollar would produce greater inflation and higher interest rates. (A lower dollar can be inflationary because it makes the relative cost of imports higher than normal. If the dollar weakens, it takes more dollars to buy foreign goods.)
2. The U. S. trade deficit continued to widen, despite efforts to promote exports through a weaker dollar—As the dollar weakens, exports should increase due to the fact that domestically manufactured goods are relatively cheaper to foreign buyers.
3. The Federal Reserve began to raise rates apparently due to the weakness in the dollar and fears of inflation—As rates rise, bond prices fall.

Bond prices continued to fall throughout the summer. On October 2nd, bond prices had reached a two-year low, then reversed to close higher on the day. This occasion was the first time that the bond market had a positive weekly close in a month's time. As bond prices were striking their lows, the stock market was hitting its highs. The stock market had been rallying for five straight years. Some analysts were concerned that the stock market valuations were too high. They deemed that stock prices were likely to fall.

Taking all of these factors into consideration, a speculator elected to buy two bond futures contracts. The anticipation was that as stock prices fell, bond prices would rise as investors took money out of the stock market and invested it into the bond market.

The trader bought two December T-bond futures contracts at 79-08 (that is, 79 and $^{8}/_{32}$ cents on the dollar). One bond contract is worth $100,000, so the contract value at the purchase price was $79,250 per contract. The bond trader was using the futures markets to obtain better leverage on the dollar. Let's say that the margin requirement for bonds at the time was $3,000 per contract. Instead of investing $158,500 in 30-year T-bonds, the trader was able to post minimal margin for the same amount of returns. Each 32nd move on a futures contract is worth $31.25, and each full-point move is worth $1,000.

Later in the week, bond prices again plunged. The huge trade deficit number released on October 14th hurt bond prices even more. By Friday, the bond market had closed at 77-30. That equated to a paper loss of 1-10 or one full point and 10/32nds or $1,312.50 per contract in the futures account. Because the trader had funded the account with a more-than-adequate margin, he or she was able to keep the position.

Over the weekend, traders began to lose confidence in the stock market. U. S. Treasury Secretary James Baker threatened to let the dollar continue its fall, which made foreign investors nervous. (If the dollar drops in value, it reduces the relative value of foreign investments. The returns that foreign investors have in U. S. assets are reduced, due to the loss in the exchange rate.)

That situation began a worldwide uncertainty and fear regarding the status of the U. S. economy, and by Sunday night, Japanese investors had begun selling stocks heavily.

When the markets opened on Monday, October 19th, panic already emerged. The Dow Jones Industrial Average plunged a record 508 points as foreign investors and U. S. portfolio managers rushed to sell stocks and buy other securities.

The bond market benefited greatly. A tremendous amount of capital rushed into the bonds as investors searched for a safe haven for their money. The cash bond market continued to rally after the futures had closed, indicating that the strength in the bond market would continue.

The aftermath of Black Monday was wrought with fear and uncertainty about the U. S. economy. Fear of a recession loomed overhead.

The Federal Reserve immediately halted the pattern of raising rates (tightening monetary policy) and began to flood the market with liquidity. The Federal Reserve added cash to the system by buying dollar-denominated securities. The increase of cash pushed interest rates lower. (Money supply and interest rates are inversely related.) The bond market continued to rally on the back of lower interest rates and higher investor demand.

As investors flocked to bonds in search of stability, bond prices rose substantially. Within one week, bond prices rose more than 12 percent. The bonds had closed at 77-30 on October 16 and finished at 86-18 by the close of trading on October 23.

Profits on the two futures contracts had quickly expanded to $14,625. (86 18/32nds minus 79 8/32nds is a difference of seven full points plus 10/32nds per contract. That is $7,312.50 per contract, or $14,625.)

Throughout the next few weeks, bond prices continued to climb, reaching a high of 90-15 the week of November 2. Throughout November, the bond market stabilized at the higher level, fluctuating between 88-00 and 89-00. By mid-November, the fears of a recession began to subside. The impact of the crash on the overall economy was not as clear, and the economy was stronger than expected. The previous concerns of higher rates began to creep back into the bond market.

Toward the end of November, bond prices began to fall. On November 27, the December T-bond closed as low as 87-02. Concerned that the pattern of higher rates would ensue, the bond trader sold the position. The trader offset the position by selling two December T-bond futures con-

tracts at the opening of trading on December 7 at 87-20. Profit on the transaction was $16,750. (87 and 20/32nds minus 79 and 8/32nds equals 8 and 12/32nds, which resulted in $8,375 per contract or $16,750.)

Traders can use the bond futures market as a short-term trading vehicle or as a substitute for cash bonds, as in this example. The trader could have invested the large sum into cash bonds and earned relatively the same dollar returns. By investing in the futures contract, however, he or she was able to get a larger percentage return on the money invested. Futures trades have advantages over cash transactions in that 1) they require less capital; 2) the contract is liquid and can be easily bought and sold; 3) the relative commission costs are often lower; and 4) the money that otherwise would have been tied up in a cash bond transaction can be invested elsewhere.

Quiz

1. The corn trader mentioned previously was successful because he or she bought the low and sold the high of the move. (true or false)
2. An aggressive gambler would likely be a good futures trader. (true or false)
3. Futures contracts are relatively liquid. (true or false)
4. Futures prices are controlled by the floor traders. (true or false)

Answers

1. False. The corn trader did not catch the low or high of the move. Corn showed signs of strength by reversing from the lows and posting higher closes. The trader became bullish because of the price action and also because the sentiment was too bearish considering the developing scenarios. While there was no way to predict the weather or other factors that contributed to the explosive move, the trader was able to capture a significant chunk of it by slowly raising the stop loss and following the market, rather than taking the first quick profit available.
2. False. A person who does not have a healthy attitude toward gambling is not likely to have a healthy attitude toward speculating in futures, either. Often, participating in the commodity markets gives the trader a sensation of excitement and risk that otherwise might not be available in his or her current job or lifestyle. Trading becomes a challenge of man or woman against the market and a destructive battle of ego instead of discipline. Sensations of greed or fear of loss take over and cause the trader to behave erratically (and most likely, to lose money).
3. True. Futures contracts are relatively liquid. While it is possible to be stuck in a locked-limit situation when a market is hit by extremes, in

general a trader can buy or sell a position with relative ease. A commodities investment is more liquid than, say, real estate or timed deposits (CDs), where your money is locked up for a period of time and might not be quick to unload. Plus, as mentioned previously with the bond trader, because the leverage of futures is greater, the amount of money required on deposit is lower. This feature enables the trader to have more capital available for other investments.

4. False. Although rumors might have it that floor traders can manipulate market prices, that statement is not true in general. Floor traders make money by scalping large volumes for quick profits. Floor traders have the advantage at times by being in the pits during a quick market move, but they pay for that advantage by buying or leasing a seat on the exchange. A seat might cost $250,000 or more, and the cost to lease a seat can exceed $3,000 per month. Seat prices and leasing fees move up and down with demand and perceived value. The price of a seat has in general increased steadily over time.

Futures trading can offer a world of opportunity to the serious investor. As with any trading program, always begin with a trading plan and sufficient capital, and approach trading like a business. With the appropriate tools and strong discipline, futures trading can offer a world of opportunity.

Chapter 2

Basics: Terms, Definitions, Trends, and Policies

Although every attempt has been made to ensure this book is up-to-date in electronic trading, there are likely to continually be advances and worse. Always check for current information.

Introduction

To be successful in futures trading, you must know all of the basic terms, definitions, trends, and policies that apply to this unique marketplace. In the previous chapter, we discussed how the futures markets came into existence. Now, it is time to discuss how they operate in today's economy.

We use many different terms to define a certain type of trade or scenario. The following section shows examples of terms, definitions, and how the words are used in everyday activity in futures trading.

Appreciation: An increase in value. If the Japanese yen appreciates relative to the U. S. dollar, one dollar would buy fewer yen. When watching the cash market, which is quoted in yen to the dollar, you would see the price decline on the screen—which actually means that the yen is gaining strength versus the dollar. With a futures contract, which is quoted in dollars per yen, if the yen appreciates, you would see the price increase. This fact is important and often causes miscommunication between brokers and clients.

NOTE

For the record, cash yen is quoted in yen to dollar, as are most currencies (except for the Euro and the British pound). On the television screen, when the financial network shows the currency market, be careful to get it correct. British pounds and the Euro, on TV and in the cash market, are often quoted in dollars per Euro or dollars per British pound. This inconsistency might cause confusion. In the futures markets, the prices are always in dollars to the currency. When a currency is strengthening versus the dollar, for example, then the futures price is going up. If the currency is weakening versus the dollar, then it is dropping in price.

Futures currency contracts are always quoted in dollars to the currency. So, if you think that a currency is going to appreciate versus the dollar, then you want to be a buyer of that currency. You want to be long in the futures contract or a buyer of calls.

Let me end this section with another note. Everything is subject to change. Always, always, always double check anything you read in order to be certain that it still applies in the market in which you wish to trade.

Arbitrage: The simultaneous purchase or sale of a contract in different markets in order to profit from discrepancies in prices between those markets

Arbitration: The procedure of settling disputes between members or between members and customers

Ask: The price at which a trader is willing to sell; also called the offer (opposite of bid)

Associated Person (AP): An individual who solicits orders, customers, or customer funds (or supervises persons performing such duties) on behalf of a *Futures Commission Merchant* (FCM), an *Introducing Broker* (IB), a *Commodity Trading Advisor* (CTA), or a *Commodity Pool Operator* (CPO)

At-the-Market: An order to buy or sell at the best price obtainable at the time the order is received; the same as entering a market order

At-the-Money: Used in reference to an option with the strike price that is equal or approximately equal to the current market price of the underlying futures contract

Backwardation (Inverted Market): When the price of the current futures contract is trading at a higher price than the deferred contracts. Usually, the price of the current futures is the closest reflection of the spot price, and the farther out you go in time, the higher the price. This situation is due to carrying charges. In an inverted market, deliveries in the near future have a higher price than those that made at a later date. This situation is due to a surge in demand in the near future (for example, expect a short-term drop in supply, but expect things to balance out later). This term is the opposite of contango.

Balance of Payments: A record, presented in balance-sheet form, of the value of all of the economic transactions between residents, business firms, governments, and any other institutions in a country and the rest of the world

Basis: The difference between the spot price and the price of futures

Bear: A person who believes that prices will move lower

Bear Market: A market in which prices are declining

Bear Spread: Usually refers to selling the nearby contract month and buying the deferred contract to profit from a change in the price relationship. You can also refer to this concept as an options position that profits from a drop in price.

Bid: The price at which a trader is willing to buy (opposite of offer or ask)

Break: A rapid and sharp decline in the market

Broker: A person or firm that handles the actual execution of all trades

Bull: A person who expects prices to rise

Bull Market: A market in which prices are rising

Buy in: To cover or close out a short position

Buy-on-Close: To buy at the end of the trading session at a price within the closing range

Buy-on-Opening: To buy at the beginning of the trading session at a price within the opening range

Call: An option to buy (go long) a security or commodity at a predetermined price within a given time period

Cancel: The act of canceling a working order, be it a day order or a GTC

Cancel-Replace: The act of canceling the quantity and/or price on a working order and replacing it with a new request. Traders can only perform cancel-replace when they want to change the quantity or price (or both). You cannot cancel-replace with a different strike price, a call versus put, or a different underlying commodity.

Car: A loose term used to describe a futures contract. This term derived from the fact that most commodity items have at one time been delivered in a railroad car.

Carrying Charges: The cost of storing a physical commodity over a period of time; includes insurance and interest lost on the invested funds (opportunity cost), as well as other incidentals

Cash Commodity: The actual physical commodity, as distinguished from a futures commodity (for example, the actual ears of corn bought and sold on the spot or cash market)

Cash Market: Market for immediate delivery and payment of commodities

Cash Settlement: Transactions generally involving futures contracts that are settled in cash, based on the contract's value on the last trading day, as opposed to the actual delivery of a commodity or financial instrument. Many index-related contracts and some livestock futures are cash settled.

Central Bank: A financial institution that has official or semi-official status in a federal government. Central banks are the instruments that the government uses to expand, contract, or stabilize the supply of money and credit. They hold the reserves of other banks, act as fiscal agents for their governments, and can issue paper money. In the United States, the central bank is the Federal Reserve. Europe has the *European Central Bank* (ECB).

Clear: The process by which a clearinghouse maintains records of all trades and settles margin flow on a daily mark-to-market basis for its clearing members

Clearing Margin: Financial safeguards to ensure that clearing members, which are usually companies and corporations, perform on their customers' open futures and option contracts. Clearing margins are distinct from customer margins that individual buyers and sellers of futures and option contracts are required to post with brokers.

Clearing Member: A member of the clearinghouse or association. All trades of a non-clearing member must be registered and eventually settled through a clearing member. Each brokerage firm is required to maintain a minimum acceptable level of equity above the inherent risks to client or firm positions. Any firm that is deemed undercapitalized at the end of the trading day is promptly liquidated, and client funds are distributed to more stable houses.

Clearinghouse: An adjunct to a commodity exchange through which transactions executed on the floor of the exchange are settled. The clearinghouse is also charged with assuring the proper conduct of delivery procedures and adequate financing of trading.

Clerk: A member or broker's employee who has been registered to work on the trading floor or in an office as an assistant

The Close: A short period at the end of the trading session during which the closing price range is established; sometimes used to refer to the closing price

Closing Range: The closing price (or price range) recorded during the period designated as the official close. Buy or sell orders deemed for the close can be filled at any level within the closing range.

Commission: The fee that a broker charges to a customer when a transaction occurs

Commission House: The same as a brokerage house or firm; buys or sells futures contracts for the accounts of customers. The commissions charged to customers generate its income.

Commitment or Commitment of Traders: A way to monitor the level of commercial and speculator participation in a contract. Traders who are registered as commercial hedgers or large or small speculators can reveal a great deal about the future direction of prices.

Commodity Futures Trading Commission (CFTC): The Commodity Futures Trading Commission, established in 1975 to regulate all commodity futures and options trading in the United States. The commission consists of a chairman, vice-chairman, and three other members, all of which are appointed by the President.

Commodity Pool: When a number of people or establishments contribute funds that are combined (pooled) for the purpose of trading futures or options

Commodity Pool Operator (CPO): An individual or organization that operates or solicits funds for a commodity pool

Commodity Trading Advisor (CTA): A person who advises others as to what to trade or who actually trades on the client's behalf. CTAs who trade for others must keep a registered track record of their performance as an advisor.

Contango: A name for a pricing situation in which futures prices become progressively higher as maturities become progressively longer. The increase reflects carrying costs such as storage, financing, and insurance (opposite of backwardation).

Contingency Order: Special instructions that you give to a broker that indicates you want an order to be executed only if certain market conditions manifold. The action is contingent upon market conditions (also referred to as an if-then situation).

Contract: A term of reference for a unit of trading. For example, one contract of corn consists of 5,000 bushels.

Contract Grade: The particular grade of commodity that is officially approved by an exchange as deliverable in settlement of a futures contract

Contract Month: The month in which futures contracts might be satisfied by making or accepting a delivery. For example, a March corn contract is up for delivery in the third week in March.

Crop Year: The period of time from one harvest to the next (varies with each commodity). For example, the crop or marketing year for soybeans begins September 1 and ends August 31. The first contract month to represent the new crop for the year is November. The contract that best represents the old crop or last major old crop marketing month is July.

Cross-Rate: In foreign exchange, the price of one currency in terms of another currency in the market of the third country. For example, a London dollar cross-rate could be the price of one U. S. dollar in terms of yen on the London market.

Day Order: An order placed for execution, if possible, during only one trading session. If the order cannot be executed that day, the order is automatically canceled. With the advent of overnight markets, many new changes have affected order placement. An order entered in T-bonds, for example, can apply to many different trading periods. If you enter a day order on or just before the Chicago exchange opens, the order is working (available for execution) all day and is then canceled at the close of the open outcry session. If you enter an order at night, to be effective during the Project A session, your order can continue to work all night and then be active during the open outcry session. If you re-enter that order, assuming that it is canceled, you are subject to being double filled.

Day Trading: Establishes and liquidates the same position or positions within the same trading day

Deferred Futures: Futures contracts that expire during the most distant months. For example, if the month is January 2001, you could refer to the December 2001 contract or even the March 2002 contract.

Deficit: When expenses exceed income. A country operates at a trading deficit when its imports exceed its exports (more money spent on goods and services than received). A trading account can go into a deficit when trading losses exceed the money that is available in the account. The account balance is negative, which some people refer to as "going D." If a trading account goes deficit, the client is responsible for the negative balance.

Delivery: The tender and receipt of an actual commodity, warehouse receipt, or other negotiable instrument covering such commodity, in the settlement of a futures contract. Also the transfer of a cash commodity from the seller of a futures contract to a buyer of a futures contract. Each futures exchange has specific procedures for delivery of a cash commodity. Some futures contracts, such as stock index futures contacts, are cash-settled.

Delivery Month: A specified month within which the delivery can be made under the terms of the futures contract

Delivery Notice: The written notice given by the seller of his or her intention to make delivery against an open short position on a particular date

Depreciate: To decrease in value. A currency depreciates when it loses value versus another currency. For example, if the Japanese yen depreciates in value versus the U. S. dollar, it takes fewer dollars to buy the same amount of yen. (There are more yen to each dollar; please see the term *appreciate* in this chapter.)

Devaluation: A substantial decrease in the relative value of a currency

Discretionary Account: When a trading account is managed by a party other than the official owner of the account (managed by a third party)

Dominant Future: The futures contract with the largest open interest

Double Fill: When then same order is executed twice by accident. When a client enters a day order, forgetting that he or she already entered it or that he or she has an existing *Good-Until-Canceled* (GTC) order already in place that is filled on each request. These mistakes can be costly and often go unnoticed (particularly in a discount account that is not being

closely monitored). The net effect is that a trader will have two of the same contact when he or she only wanted one, or the trader thinks that he or she is out of the market when actually, he or she has just added a new position. *Remember that exiting a market does not automatically cancel any corresponding orders.* All GTC orders are just that—good until filled or canceled. A double fill can also occur when a client has two offsetting orders in place (for example, a stop and a target order). If the market is volatile, it is possible to get filled on the stop and then the target (or vice-versa) quite quickly. If the trader is not paying attention, the trader could end up short in a market that he or she wishes (or thought) that he or she was out of (or long in a market where he or she was previously short). *One Order Cancels the Other* (OCO) orders exist, but few trading pits will accept them. As for electronic or Internet trading, OCO orders are not accepted to date.

Equity: The residual dollar value of a futures trading account; sometimes referred to as the liquidating value

Eurodollar: U. S. dollars held on deposit in countries other than the United States

Exchange for Physicals (EFP): A transaction generally used by two hedgers who want to exchange futures for cash positions. An EFP is a common reference in the currency market. A stop order can be placed on a currency contract that will work overnight. The market is thin, however, and movement can be erratic.

Exchange Rate: The value of one currency in terms of another

Exercise: The action taken by the holder of a call option if he or she wants to purchase the underlying futures contract, or the holder of a put option who wishes to sell the underlying contract

Fill: When an order has been executed, it is referred to as a fill (for example, "Order number 134 has been filled").

Fill or Kill: A term used as a special instruction to the floor broker to fill a contract at a specified price as quickly as possible. If the floor broker cannot fill it at the recommended price quickly, then he or she cancels the order. This special order is not accepted in most pits.

First Notice Day: The first date, which varies among commodities and exchanges, on which notices of intention to deliver are authorized. Retail traders, or anyone who is *not* intending to take delivery of the commodity, are required to exit long positions the day before the first notice day. Anyone who has a short position can hold until the last trading day, but due to the sharp decline in liquidity, this action is not recommended.

Flat: When a position has been entirely liquidated, the position is said to be flat. Backing up an order with a broker by saying, "I just sold my corn position, so I am flat and out of the market" is recommended as an additional safety measure, in order to be certain that both parties have communicated properly.

Floor Broker: A member of an exchange who executes orders in the pits

Forward Market: Refers to the trading of contracts at the current spot price for future delivery. This concept differs from a futures contract in that 1) delivery time and amount are set by the customer, and 2) the transactions are not conducted at a formal exchange.

Futures Commission Merchant: A firm or person who is engaged in soliciting or accepting and handling orders for the purchase or sale of commodities (must be registered with the NFA and CFTC).

Futures Contract: A contract traded on a futures exchange for the delivery of a specified commodity at a future time. The contract specifies the item to be delivered and the terms and conditions of delivery. This agreement is binding.

Give Up Agreement: When a broker or client decides to use a floor broker who is not associated with his or her clearing firm; usually done when shopping for the best execution. Typically, an extra fee is involved.

GLOBEX: The Chicago Mercantile Exchange's off-hours electronic trading and matching system

Going D: The act of going deficit in your account (when trading losses exceed the equity available)

GTC or Good-Until-Canceled: An order to buy or sell that is valid until either executed or canceled. Many traders place stops on GTC so that the risk level always exists. You should note that if you exit a trade on a different ticket, the GTC orders are not automatically canceled. All GTC orders are working orders until physically filled or canceled (also called an open order).

Heavy: When the market is heavy, it is not able to rally or might even be ready to decline.

Hedging: A means of limiting risk exposure by placing a trade that essentially offsets risk of the underlying position. A farmer needs to sell corn, and he can sell a corn futures contract to protect himself against falling prices.

If-Then: A situation in which you instruct your broker to watch the market, and if the order trades at a certain price, then the broker is to take action. (This action could be to cancel a stop, buy an option, exit a position, give you a call, or any other number of options.) If-then is also called a contingency order.

Initial Margin Requirement: The amount that must be placed on deposit in order to initiate a futures or short-option position. The exchange sets minimum initial margins, but each individual broker or brokerage firm reserves the right to set the requirement at any level above the minimum.

Introducing Broker (IB): A registered brokerage house that solicits and services accounts but does not execute or clear the trades. An IB passes on that responsibility to an FCM. As a result, the capital requirements of an IB are lower than that of an FCM.

Inverted Market: A futures market in which the nearer months are selling at premiums to more distant months (see *backwardation*)

Last Trading Day: The final day that trading can take place on a particular contract for a certain month. Any outstanding contracts on the close of trading on that day must be settled by delivery or cash settlement.

Limit Move: Up or down movement when a market is trading at its maximum daily price fluctuation. The exchange sets the limit levels, which often expand if a market locks limit.

Limit Order: An order that specifies a particular price or time to be executed. A buy limit order must be filled only at the stated price or lower (better). A sell limit order must be filled at the stated price or higher (better).
Liquidate: Same as offset or going flat; a closing of a long position by selling or a closing of a short position by buying. To liquidate a position, you must buy or sell back the same contract that you currently have in your account. This contract must be same contract month, strike price, and so on. Otherwise, you end up with a spread in your account (which happens more often than you might think).
Liquidity: When a market has a high level of trading activity, it is said to be liquid. Liquid markets tend to have fewer erratic price fluctuations.
Local: A floor trader who is responsible for his or her own account
Locked Limit: When a market move is so extreme that there are no further trades at the daily limit level (the maximum price fluctuation allowed per day). For example, news of a drought in the Midwest can cause soybeans to lock limit up for days. In other words, traders anticipate the price move to be so strong that no willing sellers exist at the day's high. Traders need to wait until the first available trade. A market can come off limit throughout the day if the fundamental conditions warrant, or it might not trade for several days. Several ways exist to protect yourself from limit moves by using options.
Long: When you buy a futures contract in anticipation of the price to rise, you are long in the market. Long is the opposite of short.
Maintenance Margin: The amount of equity that must be maintained on deposit in order to continue to hold a futures position(s). This amount is usually a percentage of the initial margin requirement.
Margin Call: The demand for additional funds if your account drops below the maintenance level. Most margin calls must be met by wire or liquidation by the close of the trading day. Failure to meet a margin call can result in a liquidation of your positions. In general, margin calls are to be avoided at all costs. Typically, they are a sign that you are trading with too little capital or are overtrading your account. Making a habit of meeting margin calls can prove to be a financial disaster.
Market Order: An order for immediate execution at the next available price
Market-If-Touched (MIT): A price order that becomes a market order if the stated price is reached
Market-on-Close: An order in which the floor broker must buy or sell a contract on the close at the best available price. A closing range is often established, and this order can be filled at any level within the closing range.
Maximum Daily Price Fluctuation: The maximum amount that the contract price can change up or down in one trading session. The exchange sets the levels (also called the daily limit).
Minimum Price Fluctuations: Also called the tick size; the smallest increment in which a contract can trade. For example, each tick in gold is 10 cents per ounce. Thus, the gold trades at $300.00, $300.10, $300.20, and so on.

Nearbys: The nearest delivery months of a futures contract series
Nominal Price or Nominal Settlement: A price quotation for a period in which no actual trading took place. For example, many liquid options will go for days without trading. (No one agrees on a price.) At the close of each day, the exchange posts a nominal settlement determined by the options pricing model. No trade actually took place. If you had an order working, it would not have been filled regardless of the price.
Offer: The price at which a trader is willing to sell (opposite of bid; also called the ask or asking price)
Offset: To liquidate a position
Open Interest: Number of open positions still outstanding, and the number of new positions in the market that have not been liquidated, offset, exercised, or expired
Open Order: An order that is good until canceled or executed; same as GTC
The Open or Opening Range: The varying time period at the beginning of the trading session in which all opening transactions are made. There is often an opening range within which all orders that are designed to be filled at the open will be executed.
Or Better: An additional comment with a limit order to prevent it from being confused with a stop order
Order-Cancels-Order (OCO): An order that instructs the floor broker to automatically cancel one order if the other is filled. Typically, the broker assigns two floor order numbers and is responsible for executing the trade properly. As you can imagine, few trading pits accept this type of order.
Per Side: Fees are often charged per side, both on the initiating transaction and on the offsetting transaction. Sometimes commissions are listed per side in order to appear cheaper, either in advertising or on your statement.
Position Limit: The maximum number of contracts, net long or net short, that one person or firm can hold (does not apply to hedgers)
Project A: The Chicago Board of Trade's after-hours electronic order entry and matching system
Premium: The amount for which an option trades; the cost of a particular option that is trading. This term also refers to the amount that a product is trading over the cash or over fair value.
Put: An option to sell a commodity at a predetermined price within a specified period of time
Pyramiding: The act of using profits from one position to margin another
Rally: An upward movement in price
Roundturn: The purchase and sale of a contract. Commissions are usually charged per round turn. Sometimes brokers will advertise a rate that is actually per side. The true commission turns out to be double what was advertised.
Scalp: To trade for small gains (often several times within one hour). Floor traders or locals are usually scalpers.

Short: To be in a position that makes money on a price decline. Futures traders can sell a contract without previously owning it. Thus, they are able to benefit quickly from a drop in price. You can also be short the market (bearish) by owning a put option that increases in value if the market declines. This term is the opposite of being long.
Short Squeeze: When the market rallies quickly, forcing traders who were short to liquidate their positions
Spot: Market of immediate delivery of the product and immediate payment; also, the nearest delivery month futures contract
Spread: Basis: The difference between the spot price and futures price. Intermarket spread: To take a long position in one market and a short position in another (buy wheat and sell corn). Calendar spread (intramarket spread): To take a position in the same market but at different delivery months (one long and one short), such as buying May corn and selling September corn)
Stop-Close-Only (SCO): An order that instructs the broker to execute a stop order if (and only if) it should be executed based on the value of the anticipated closing range. For example, if you have an order to sell SCO, it would only be executed if the market were trading at or below your designated level on the close.
Stop-Limit Order: A variation of a stop order in which a trade must be executed at the exact price or better. The order remains in place until it can be filled at the desired level.
Stop Order: An order that becomes a market order as soon as the price is touched. Buy stops are placed above the market price. Sell stops are placed below the market price.
Tick: Minimum price fluctuation (varies per commodity)
Volume: The number of purchases or sales of a futures contract made during a specified time

More on Commodity Exchanges

The futures exchanges are an open, competitive marketplace where traders make bids and offers for a commodity. When a trade takes place, the exchange records the price of the transaction. As each trade takes place, the prices are punched into computer terminals that distribute the price information all around the world. By definition, a futures exchange is a place that is designed to facilitate trade, and the exchange itself does not participate in the supply of the actual commodity. No gold exists at the Commodity Exchange in New York, and no hogs are available at the Chicago Mercantile Exchange.

Millions of traders all around the world rely on the price transmission from the exchanges to make their trading decisions, so quick and accurate relay of the data is extremely important. To accomplish this goal, exchanges employ clerks to enter trade data as it occurs. These clerks, or market reporters, are perched around and sometimes inside the pits. They are on

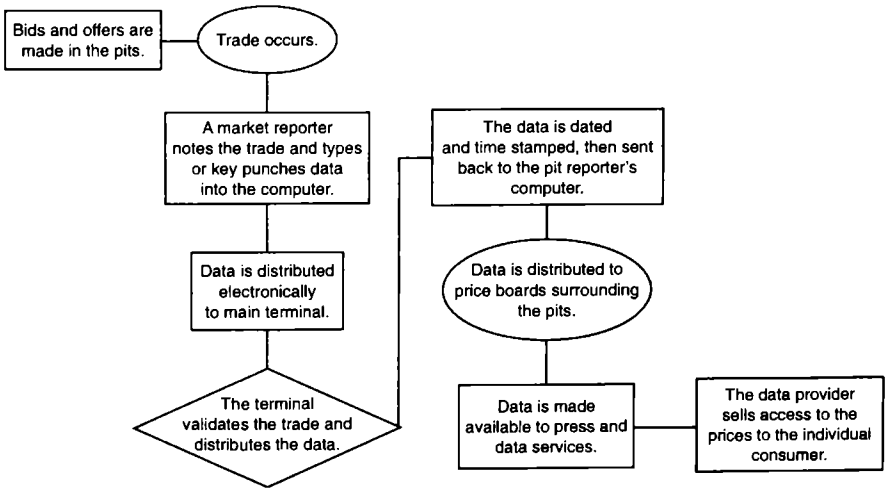
platforms above the trading action so that they can get a clear view of each transaction. Their primary responsibility is to type the trade into a computer as it occurs.

The pit terminals then relay the messages via an electronic network to a large computer system. The system validates the price quote for accuracy and then distributes it back to the terminal, where it is time stamped and dated as an official trade. The message is also relayed to the many price boards that line the walls surrounding the pits, so that every trader gets a view of the price action. There are managers who also evaluate prices as they are posted in order to ensure their validity. They might make changes, additions, or deletions as the day progresses.

The price information produced by this action is made available to various press companies. These news and data providers pay a fee for the information and redistribute it to thousands of traders around the world. Most people who are outside the exchange subscribe to a data service in order to obtain the current prices. The fees vary by the service required.

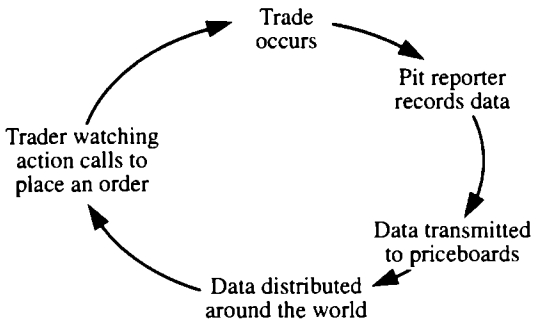
Many different forms of price information are of use to the subscriber. For example, market news such as crop reports, opening calls, overseas trading, cash market fluctuations, and so on are typically available with a subscription. Price data, which includes the open, intra-day prices as well as the settlement, is part of the service. A subscriber can request real-time prices (up to the second reports, including bids and offers), intra-day delayed data (updates every 10 minutes), or end-of-day data (a summary of the day's action), depending on his or her trading needs. Most data providers will also make available technical studies, volume, open interest, and options information.

The Route of Price Data



Price information and trading action complete a giant circle (refer to Figure 2-1). A trade occurs in the pits and is posted on the price boards. Floor traders take action on the price move. Trade prices are transmitted

Figure 2-1 *The circle of trade*



to millions of individuals around the world. The price action that occurs in the pits entices a hedger or speculator to take some action. The trader might call the floor and place an order, and another trade takes place. The result of that trade is transmitted again around the world and entices another participant to take action. The order flow is within the pit from broker to local, as well as from outside the pit as orders are phoned into the exchange. Let's take a look at how an order from the outside is handled on the trading floor.

Outside participants on the trading floor usually utilize a commission brokerage firm, such as the *Futures Commission Merchant* (FCM), in order to execute the trades. The client usually has the choice of calling a personal broker or an order desk representative at the firm, who then calls the pits. Also, the client might be given access to the floor directly. Typically, only experienced traders with substantial capital can phone the floor directly. Most have to contact a brokerage house first.

When an order is phoned into the trading floor, it reaches one of the many desks that surround the pits. Exchange floors are generally large, and the open outcry pits are clustered in the center. Order desks are sometimes squeezed between the octagonal pits. The majority of the desks are around the perimeter of the pit clusters and line along the walls in bleacher style, stacked on top of each other at an angle.

When a desk clerk receives an order, he or she might hand-signal the order into the pit or send the order into the pit on paper. Either way, as the clerk is processing the order, a hard copy receipt of the order is time stamped to record the time of entry.

Flash Fills or Arbs

Market orders that come into the pits can be flash filled, which means that the order clerk takes the request to buy or sell and gestures a signal to the pit. Each pit is filled with locals and brokers that are fighting each other for trades and profits. To help facilitate the transactions that come from the surrounding desks, *arbitrage* (arb.) clerks line the outer perimeter of the pit and face the desks. Their job is to communicate trade action

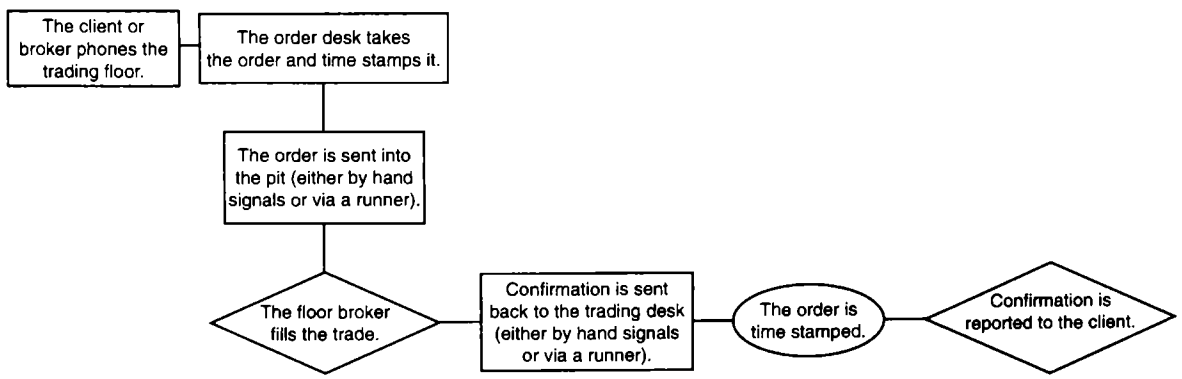
between the desk and the floor broker. One brokerage firm might employ the desk person, the clerk, and the broker. Floor brokers, however, can also be independent agents and employ their own arb. clerks to help facilitate business. The arb. clerk receives the hand signal from the desk and tells the broker what to execute. If the order was to sell 10 contracts at the market, the broker then announces that he has 10 contracts for sale. Other brokers and locals might want to buy at that level and shout and gesture their price. If they are selling at the market, then they will trade with the best available bid that they see. Once the broker or local confirms a trade with a colleague, he or she then notes the trade on the card and tells the arb. clerk the trading price. The arb. clerk then turns to the desk and hand-signals the execution price. The desk clerk notes the price, time stamps the order again, and communicates the price to the person on the phone. The entire process can take as little as five seconds.

Flash fills are available in most actively traded financial contracts. In some cases, flash fills are available if the order meets the minimum in size requirement (5, 10, or even 25 contract minimums). The system is designed to facilitate a large volume of transactions in the shortest amount of time. In less actively traded pits or for orders that are not close to the current market, the clerk enters the orders via a runner.

Runner-Facilitated or Written Orders

When an order is called to the desk, the clerk will write an order ticket and time stamp the order. He or she then hands the order to a runner. The runner literally runs from the desk to the pit and back, collecting and delivering orders. The runner runs the order to the appropriate pit and delivers it to the filling broker. If necessary, the runner will wait for the broker to fill the order. The runner then runs back to the desk and delivers the filled ticket. The floor desk then time stamps the order and reports it to the person who phoned in the order.

Route of a Phone Order



Electronic Order Entry

In conjunction with improvements in technology, order entry has improved, as well. Most trading floors have adopted electronic order entry systems. Electronic order entry has helped reduce turnaround time as well as errors and discrepancies with regard to orders and fills going to and from the pits. Large brokerage firms are often equipped with electronic terminals that are designed to route orders directly to the pits. There are many different brands of electronic order entry systems, and they are likely to change and improve over time. One example of the latest in order-routing systems is called TOPS ROUTE, or simply TOPS.

Large brokerage firms are equipped with terminals in branch offices as well as on the trading floor. Brokers from satellite offices enter client orders into the system by typing the order on the terminal keyboard. The system makes a record of the time of entry. The order is then routed directly to the trading floor, where an order is printed from the terminal. The order is then either flashed or run into the pit. When the confirmation returns, the floor clerk then types the fill price into the system, and a confirmation ticket is printed on the terminal in the originating office. The time of each step is automatically recorded in the system. In many cases, the electronic terminal is located directly in the pit, which makes the process even faster. Often, floor brokers and traders will carry handheld devices in which they record orders and transactions, which reduces the amount of paperwork required and further expedites the process.

Time Stamps

Orders are time stamped frequently, because the exchange must have a record of when the order is placed, when it goes into the pit, when it arrives back at the trading desk, and when it is reported to the client. This process is part of what is required to keep the system efficient and regulated. Time stamps assist the process through a multitude of ways. Not only does marking the time prove that the order was entered, but it can also help the exchange evaluate whether it was filled in a timely manner. For example, market orders should be filled as quickly as possible from the time of receipt. Limit orders and stop orders depend on market action as to whether or not they should be filled, and time stamps help verify that fact. If every party takes accurate record of the time in which it handled the order, it becomes easier to identify where any errors might have occurred. Let's look at several examples:

1. The broker phones the floor with a limit order to buy five contracts of soybeans at $5.46 per bushel at 9:33 A.M. After a few minutes have passed, the client and broker both notice that soybeans have made a low of $5.45 and a high of $5.52 on the day so far. Should the order to buy at $5.46 be filled? The rules say that a limit order must be filled if the market trades below the stated price. By looking at the high and low of the day, it appears that the client should have bought the five contracts at $5.46. But what time did the order reach the

floor? If the low occurred before the order entered the pit, then the order might not have been filled. At this point, we need to refer to the time of sales to obtain the answer.

NOTE

For assistance with understanding the types of orders used in the following examples, refer to Chapter 5, "Buying and Selling Futures."

Time of Sales

Time of Sales—Soybeans.

Opens at 9:30 A.M. Central Time
9:30: 546 1/2, 546 1/4, 546, 546 1/4, 546 1/2, 546 3/4
9:31: 546 1/2, 546 1/4, **546, 545 3/4 , 545 1/2**
9:32: **545, 545 1/4, 545 3/4 ,**
9:33: **546**, 546 1/4, 546 1/2, 546 1/4, 546 1/2, 546 3/4
9:34: 546 3/4 , 546 1/2, 546 3/4
9:35: 546 1/2, 546 1/4, 546 1/4, 546 1/4, 546 1/2
9:36: 546 3/4 , 547, 547 1/4, 547 1/2
9:37: 547 1/2, 547 3/4 , 548
9:38: 548 1/4, 548 1/2, 548 3/4 , 549
9:39: 549 1/4, 549 1/2, 549 3/4 , 550
9:40: 550 1/4, 550 1/2, 550 3/4 , 551
9:41: 551 1/4, 551 1/2, 551 3/4 , 552

Looking closely at these prices, you can see that there were several times in which the market traded at or below $5.46. The order was entered at 9:33 A.M., as indicated by the time stamp. There was one trade at $5.46 during the minute of 9:33 A.M., but no trades occurred below that price. If the order was entered on the trading floor and then was run into the pits, the likelihood that the floor broker had the order in hand within the same minute is slim. Even if he or she did have possession of the order, the odds of being able to fill the ticket are minimal, particularly because the market traded at that price only one time before it began to head higher quickly.

You can see how important it is for the orders to be time stamped. This time stamp is issued for the protection of both broker and client. In this situation, the broker is not responsible for a fill price at $5.46. Realistically, the order could not have been filled. Let's look at another example:

2. A trader calls the floor and enters a limit order to buy 15 contracts of December gold at $280 per ounce or better. The time of entry is recorded as 8:31 A.M., and the last trade was $279.90. The order was entered to "buy at $280 even or better," which means $280 or less (not to be confused with a stop order).

Time of Sales—Gold.

Opens 8:20 A.M. Eastern Time
8:30: 281.00, 281.10, 280.00, 279.90
8:31: **279.90, 279.80, 279.90, 280.00**
8:32: 280.10, 280.20, 280.30, 280.40
8:33: 280.30, 280.20, **280.00, 280.00**
8:34: **280.00, 279.90, 280.00,** 280.10
8:35: 280.20, 280.30, 280.40, 280.50
8:36: 280.60, 280.70, 281.00, 281.20, 281.30
8:37: 281.50, 281.90, 282.20, 283.00, 283.50

The order was entered at 8:31 A.M. During that minute, several trades occurred where the order might have been filled. Possibly, the order might not have been filled during this time, considering that the broker might not have had the order in hand. Notice that there were several trades at or below $280 at 8:33 A.M. and 8:34 A.M. The market then began to head higher. According to this reading of time of sales, the order to buy at $280 or better should have been filled. The primary reason is because there was a trade below the stated price ($279.90). In this situation, the broker owes the client a fill at $280.

What happens if there are discrepancies concerning the price at which an order is filled? For example, in some cases, stop orders are filled at prices that are far and wide from the stated price. In many cases, there are valid reasons for the price differential. In other cases, there might have been a mistake. Consider another example:

3. Before the open, a trader enters a stop order to buy one contract of June Treasury bonds (T-bonds) at 99-12 stop. (A stop order becomes a market order when there is a trade at the stated price.) The market opens at 7:20 A.M. Central Time. At 7:30 A.M., the unemployment report is released and shows a surprising number of unemployed persons. This situation implies that the economy might be slowing and is bullish for the T-bond market. The market explodes to the upside, and the buy stop is filled at 100-12. This amount is $1,000 worse than the trader expected. He or she had originally placed the order to buy bonds at 99-12, and the order was filled at 100-12—one full point worse. Obviously, the trader is dismayed and demands to see the time of sales. Does he have a valid point? Is he owed money? Let's check and see.

Time of Sales—Treasury Bonds.

The market opens at 7:20 A.M. Central Time.
7:28: 98-20, 98-21, 98-20
7:29: 98-20, 98-21, 98-22, 98-23, 98-24
7:30 (f): 98-25, 98-26, 99-**12**, 99-20, 99-31
7:31 (f): 100-03, 100-05, 100-10, 100-15, 100-24
7:32 (f): 100-28, 100-22, 100-20, 100-18, 100-16
7:33 (f): 100-14, **100-10, 100-08, 100-10,** 100-08
7:34 (f): 100-10, 100-12, 100-14, 100-16, 100-18

7:35 (f): 100-20, 100-23, 100-24, 100-25, 100-26
7:36: 100-27, 100-28, 100-29, 100-30, 100-31

Buy stop orders become market orders when there is a trade at or above the stated price. Notice that the first trade that triggered the stop order was 99-12, when the market went from 98-26 to 99-12 as the news was being released. Note that the next few trades jumped to 99-20, 99-31, 100-03, and so on. The market conditions at that moment were extreme; the market was not trading in an orderly fashion. Instead of trading every tick, it was jumping and skipping higher. When market conditions become extreme, the exchange designates the market as a fast market. Fast-market conditions are denoted when the prices are moving quickly. During fast-market conditions, the floor brokers are not held, which means that they are given more time and flexibility to fill orders as fast as they can and are not necessarily bound to a price.

In this situation, the trader was able to fill the buy stop order at 100-10. Note that at 7:33 A.M., the market traded at 100-10, then down to 100-08 and back up to 100-10. This situation is the first time that the market traded on a down tick since the number had been released. (Down tick means that the trade price was lower than the previous trade.) This event is the first sign that the market might be calming (and the first opportunity that the broker might have to fill his or her buy orders). Keep in mind that the broker might be holding orders to buy at 99-10, 99-11, 99-12, 99-25, 99-26, and so on. Not only is the broker trying to execute the lower stop orders, but new orders are being triggered as the market trades higher and higher. In this situation, it appears that the broker filled the order at an appropriate price. This situation is unfortunate for the trader, but the market conditions dictated the price. These risks are inherent in futures trading.

The "Three-Minute" Rule

As you gain experience trading in the futures markets, you might hear of a rule called the three-minute rule. This rule is an unwritten policy in which a broker is afforded a reasonable amount of time to fill an order, regardless of the market conditions. The time frame is usually regarded as three minutes. Although not cast in stone, when evaluating a fill price on a market order, limit order, and stop order, consider that the order should have been able to be filled within three minutes—provided that the conditions were not fast conditions.

Opening and Closing Range

When an order is placed at the open or close, it can be filled anywhere within the opening or closing range. Based on the trades that occur within the last few minutes of the close, the exchange determines the official range for that session. The exchange also releases the official settlement price for the contract that day. Depending on the volume and volatility of the open or close, the range might be wide or relatively narrow. Orders to

buy or sell are considered valid fills as long as they are filled within the limits of the opening or closing range. For example, if a trader places an order to buy one December S&P contract market-on-close, the fill price could be much different than the actual settlement price of that day. If the closing range is $1400.00 to $1401.10 and the settlement is $1400.40, the order to buy at market-on-close could be filled as high as $1401.10 and still be considered a valid price.

Possibilities always exist that an order might not be filled as desired. Whenever there is a discrepancy against the price at which an order is filled, always consider the following points:

1. What time did the trades take place?
2. Was there enough time for the broker to receive the order? Keep in mind that orders slated for the open or close must be entered with plenty of time to spare. Brokers will often stop accepting orders for the open within three to five minutes before the opening bell. Brokers also might require orders for the close to be entered as much as five minutes before the closing bell (for their own protection).
3. How were the market conditions? Was the market in a fast market?
4. How long after the trade was triggered was the broker able to fill the order? Was there a substantial amount of time in which to accomplish the task?
5. Were there any counter-trend ticks (up or down ticks) that would have given the broker a chance to fill the order?

Price Adjustment

If, after evaluating the previous possibilities, you still determine that the fill was not valid, then you can ask the broker for an adjustment. Most brokers will recognize when they are at fault, because mistakes are simply a part of the business. If, after reviewing the facts, the broker agrees that he or she is in error, he or she can credit your account with the appropriate amount of cash. Consider the following example:

> A trader places an order to buy 10 contracts of November soybeans at $5.35. The floor clerk takes the order and hands it to the runner. The runner mistakes the order as an order for corn and runs the order to the corn pit. Meanwhile, the November soybean contract is trading at $5.35 and lower. The order should have been filled if the broker had it in hand. By the time the runner realizes the mistake, three minutes have passed. The runner hurries to the correct pit and hands the broker the order, apologizing for the mistake. The broker notes that the order should have been filled by now and fills it at the next available price. The November soybeans are now trading at $5.37, and consequently, the order to buy at $5.35 is filled at $5.37. The difference in price of 2 cents in a soybean contract represents $100. The order was to buy 10 contracts, so the exchange must give the trader $100 × 10 contracts, or $1,000. The broker notes that the trade will be cash adjusted in order to reflect the appropriate price. The fill is

reported as a buy at $5.37, and the client will be adjusted a cash amount of $1,000 to make up for the mistake. In this situation, the party responsible for the mistake is the employer of the runner (could be the broker or the brokerage company). As a rule, brokers and firms will honor their mistakes or the mistakes that their employees make, because this process is a large part of maintaining the integrity of the futures markets.

Here are some examples of how errors can occur and who is responsible:

1. The trader calls the trading floor and places an order to buy. The clerk accidentally hand-signals an order to sell into the pit. The contract is sold instead of bought. The responsibility goes to the floor clerk and his or her employer.
2. A trader calls the trading floor and places an order to buy. After receiving the confirmation, the trader realizes that he meant to say *sell*. This error is the trader's responsibility.
3. A client calls a brokerage firm and places an order to buy. When the broker calls the floor, he or she says *sell*. The contract is sold. The responsibility falls on the shoulders of the broker and the brokerage firm.
4. The client calls the broker and places an order to buy November soybeans at the market. Upon confirmation, the client realizes that the order should have been for August soybeans. The responsibility is the client's.
5. A trader places an order to buy at $5.35. The day passes, and the trader does not receive a confirmation. The floor broker misfiled the order and did not fill the order. The floor broker takes responsibility for this error.
6. A retail broker gives an order to buy to the trading desk. The trade desk calls the floor and accidentally says sell. The responsibility falls on the employer of the trade desk clerk (usually the brokerage firm).
7. An arb. clerk misreads a hand signal coming from the trading floor desk and gives an incorrect order to the filling broker. The order is filled incorrectly. The responsibility falls on the arb. clerk's employer (usually the floor broker).

Sometimes, it is hard to determine which party is responsible. In some cases, the mistake might be split between two or more parties. Possibly, more than one party can make a mistake. Sometimes these mistakes snowball into larger problems; however, more often than not, resolution is a simple process. When nobody is willing to accept the blame for a mistake, however, the issue is carried into arbitration.

Arbitration

Part of the transaction fees that the exchange charges serve to support the arbitration committee. The arbitration committee is a floor-elected group of officials that are appointed to settle disputes among traders, bro-

kers, locals, and firms. This service is essentially a free legal service for the participants. The panel usually consists of both brokers and traders, in order to keep the decisions non-biased. The members evaluate all of the arguments, time of sales, and other bits of information and help the parties come to the best conclusion.

As technology has improved over the years, the risk of errors has decreased. By utilizing the functions inherent in the order-entry process, traders and brokers can reduce the amount of discrepancies and operate their businesses with fewer interruptions.

More on Online Trading

Although there is so much talk about the introduction of electronic trading, all traders should consider the many pros and cons before trading. First of all, a difference exists between electronic trading and online trading. As the open outcry phenomenon slowly disappears around the globe, many traders are leaving the floor to trade electronically. Markets are now available on Globex and Eurex and many other platforms. Most professional traders have direct access to these terminals to see the market bids and offers as well as the size of each potential transaction. Retail traders typically do not have access to these terminals directly but can trade electronic markets via an online brokerage account. Traders can either enter their orders directly via the Internet or call a broker who will place the order online for them.

Many factors need to be considered when determining whether online trading is for you. Patrick Lafferty of FuturesView.com had the following points to make: The Good and The Bad side of online trading. I of course added my own section: The Ugly.

The Good

Speed! In only a matter of seconds, your order is reaching its destination and headed toward the floor!
Control! You're not relying on anyone to place your orders. You are not waiting on anyone to call you back and report your fills. Virtually everything that is transpiring is done so by your hand.
Cost! Most online trading accounts are charged a lower commission rate.
Don't have to deal with a broker! If you've ever had your broker talk you out of a trade that ends up being a winner, you know about this one.
Electronic statements! Most online brokerages will supply you with "marked to the market" position analysis so that you can follow your account status as it fluctuates.
Sounds cool! Of course, it's cool, and all of your friends will look at you with admiration (and probably shock) when you mention that you are an "online futures trader."

The Bad

Errors! If you make a mistake placing your order, there's nobody to catch it.
News! It's a fast moving world out there. A good "live" broker is often one of the best sources for updates on current fundamental events.
Technical insight! Depending on how much experience you have with the charts, there may be times when a good live broker's confirming analysis might come in handy to answer any questions.
Don't get to deal with a broker! Working with a good broker is more times than not going to keep you out of potential trouble.
Higher margin requirements! For their own protection, many brokerage firms will charge a slightly higher margin than a full-service firm will.

The Ugly

Double fills! Many times an Internet order entry system gets backlogged and might be running slowly. If you place an order and the system does not give you a confirmation right away, you may be concerned with the status of your position. If you need to exit a trade, you may be inclined to enter the order again, which may result in *two* fills.
Double fills again! If you forget about an open order and place an offsetting order, you may be awarded *two* fills.
Types of orders! To date, many online brokerage accounts have limitations as to the type of order that can be entered. Stop orders, spread orders, and various option order entries have yet to be perfected. Calling a broker, trading room, or floor might be your best alternative.
Bids and offers! Markets that still trade via open outcry often do not post accurate bids and offers on various quote screens. You may get a much different fill price than you would have anticipated.
Calculation errors! If you do not calculate the margin requirement, cost of option, or risk parameters correctly, you may find yourself in a trade that is far more expensive than you intended.

This is not to say that online trading does not offer tremendous opportunity for growth; even direct trading on electronic terminals has much room for improvement. It is just that for the beginning investor, or a trader that needs specific market information, online trading may not be the avenue of choice. The entire concept behind the "open outcry" system on the trading floors is to give every member of the pit equal access to potential trades. Electronic trading to date does not match some of those advantages, although it certainly is the wave of the future.

Stocks versus Futures

Certainly, the 1990s were an extraordinary time for the United States. We experienced considerable growth, low inflation, and a booming equity market. Toward the end of 1999 and into 2000, the Internet craze catapulted stocks toward lofty levels. People made millions in the market—

millions that could just as easily been lost if companies began to falter. For years, stocks were considered a safe investment, but as speculation in the marketplace began to grow, there was considerably more volatility and more risk involved in the stock market. For every risk, however, there is a reward. As the saying goes, "the greater the risk, the greater the potential for return." That sentiment is what has attracted traders to the futures markets over the years: the potential for return. So, how is it that stocks differ from futures?

The stock of a corporation is ownership of that corporation as represented by shares. Shares are a claim on the corporation's earnings and assets. A stock exchange facilitates the transfer of ownership of shares of a corporation.

A futures contract is a contract traded on a futures exchange for the delivery of a specified commodity at a future time. The contract specifies the item to be delivered and the terms and conditions of the delivery. Unlike stocks, there is no physical transfer of ownership. A futures contract is merely a representation of the promise to deliver a commodity at a later date. These contracts to deliver are bought and sold on an exchange for speculative profit.

Time is important when trading commodities. You can hold stocks in your portfolio for decades, because they do not have an expiration date. Futures, however, do expire. Each contract has a listed month and delivery date. A small percentage of traders hold a position into the delivery date.

Margin is also an important consideration when trading stock versus trading futures. Currently, the required margin to trade stocks is 50 percent of the total value. The number is set by the Federal Reserve and can change at any time. Qualified investors can buy stocks with 50 percent margin; the brokerage company considers the other 50 percent of cash that is not required to be posted as a loan. The investor is charged interest and owes the unpaid balance as debt.

Example: Buying $10,000 Worth of a Stock.

Buy 100 shares of XYZ at $100/share.

(100 share × $100 per share = $10,000)

XYZ increases $5/share.

The account value increases by $500.

(100 shares × $5/share = $500)

Return on investment = 5 percent

($500/$10,000 = .05 = 5 percent)

Example: Buying $20,000 Worth of a Stock with a 50-Percent Margin.

Buy 200 shares of XYZ at $100/share with 50 percent margin.

(200 shares × $100/share) × .50 = $10,000

XYZ increases by $5 per share.

The account value increases by $1,000.

(200 shares × $5/share = $1,000)
Return on investment = 10 percent
($1,000/$10,000 = .10 = 10 percent), excluding interest payment

By buying the stock on margin, the investor increased returns by 5 percent (or, in other words, was able to double the potential return).

Futures are also traded on margin. The margin put forth is a good-faith payment designed to absorb price fluctuations until the actual delivery date of the commodity. This margin is not considered a debt or partial payment. Margin on commodities can be as little as three percent of the contract value.

Example: Buying a Commodity without Using Margin.

Buy 100 ounces of gold at $300 per ounce.
Cost: (100 ounces × $300/ounce) = $30,000
Gold increases in value $10 per ounce.
The account increases by $1,000 (100 ounces × $10/ounce).
Return on investment: 3.3 percent ($1,000/$30,000 = .033 = 3.3 percent)

Example: Buying a Commodity via a Futures Contract.

Buy one futures contract of gold at $4,300 per ounce.
Contract size is 100 ounces.
Margin requirement for the position is $1,000.
Gold increases by $10 per ounce.
The account size increases by $1,000 ($10/ounce × 100 ounces = $1,000).
Return on investment is 100 percent ($1,000/$1,000 = 1 = 100 percent).

By investing in the futures contract, the investor was able to dramatically increase the rate of return.

Quiz

1. On the trading floor, an arb. clerk is otherwise known as an arbitration clerk. (true or false)
2. What year was the CFTC established?
3. Futures margins are set by the Federal Reserve Bank. (true or false)
4. Futures contracts depreciate in value over time. (true or false)
5. Futures exchanges serve as locations in which to exchange commodity items. (true or false)
6. Trading pits are designed to make order execution as efficient as possible. (true or false)

7. Price data is made available to anyone who is willing to pay for it. (true or false)
8. Describe the route of a phone order.
9. A client calls to enter an order, and the conversation goes as follows:

   Client: *Buy* one March S&P contract at the market.
   Clerk: OK. I am going to *sell* one March S&P at the market. Correct?
   Client: Yes
   Clerk: You are filled. *Sold* one at $1401.
   Client: Wait! I said *buy*!

   Who is responsible for the error?

10. A buy stop is entered at $280 in gold well before the open. (A buy stop becomes a market order to buy when gold trades at $280 or higher.) Considering the following time of sales, what is the best price at which the order could be filled? What is the worst price that the trader could expect within the three-minute rule?

    Gold opens at 8:20 A.M. Eastern time
    8:20: 279.00, 279.10, 279.20, 279.30
    8:21: 279.40, 279.60, 279.90
    8:22: 280.50, 281.00, 281.50, 282.00
    8:23: 283.00, 282.50, 283.00
    8:24: 283.00, 282.50, 283.00, 283.50
    8:25: 284.00, 284.50, 285.00, 284.50
    8:26: 284.00, 283.50, 284.00, 283.50

Answers

1. False. On the floor, the arb. clerk is also known as the arbitrage clerk.
2. The CFTC was established in 1975. The primary purpose was to protect the rights of participants in the commodity markets by setting industry standards.
3. False. Futures margins are set by the individual exchanges. Brokerage firms also reserve the right to set their own margins at any level above the exchange minimum. The Federal Reserve sets the margin limit for stock trading.
4. False. Although in theory, certain aspects of a futures contract depreciate over time, such as the cost of carry, futures prices do not necessarily depreciate in value over that time. Futures prices converge to the spot price over time, and the spot price could be moving higher.
5. False. Futures exchanges serve as a location to facilitate the traded of futures contracts, not the actual commodity.
6. True. Open outcry remains one of the most efficient means of price discovery.

7. True. All futures trades are public record. Prices are available in major newspapers as well as on electronic data distribution.
8. The client contacts the broker with an order; the broker calls the floor order desk with the order; the floor desk transmits the order to the pit (via hand signal or runner); the trade occurs; the pit broker relays the fill to the order desk (via an arb. clerk or runner); the order desk contacts the broker with the fill; and the broker contacts the client.
9. This scenario is an example of a split. Although the client said buy, the clerk repeated the word sell and the client agreed. For this reason, all order lines are recorded. Without the ability to confirm this type of conversation, there would be many disagreements. Everyone is certain that he or she said or heard one thing, but without the tape to prove it, many dollars would be lost or paid unnecessarily. The dollar amount of the error (winner or loser) will be split between the client and clerk.
10. The first trade at or above $280.00 is $280.50 at 8:22 A.M. This price would be the best price at which the order could be filled. The market is jumping higher in this example. The worst-case scenario might be that the order is filled as high as $283.50 at the end of 8:24 A.M. (Some would argue $284, depending on the commodity and conditions.) If the market was under a fast market, the fill could be higher still.

Chapter 3

Beginnings: What Affects Prices?

Introduction

In this book, our goal is to differentiate the material from other texts by providing hands-on information that you can only learn by experience. Many textbooks that discuss the commodity markets usually do not explain the mechanics of trading. For example, how do you read prices in the newspaper? How do you read prices on a computer screen? What is the corresponding value of the price move? How do you enter orders correctly? What should you expect from your broker? What are margins and how are they calculated?

During my career as a futures broker, I encountered many questions that I could only answer because I had participated in the markets for some time. Accumulating the experience in these chapters is important. Keep this book handy, and use it as a guideline. Also keep in mind, however, that things do change. *Always triple check before you put your money or someone else's money into the markets.*

Contract Size

Every contract has its own size and deliverable grade (refer to Figure 3-1). For example, one *Chicago Board of Trade* (CBOT) corn contract represents 5,000 bushels of No. 2 yellow corn. One CBOT *Treasury bond* (T-bond) contract represents a $100,000 T-bond that matures at least 15 years from the first day of the delivery month. The product might not be callable and is based on a six percent standard. Although it might seem confusing at first, most contract information is readily available and is easy to interpret. Most traders do not need to know the delivery standard of a futures contract, because they are not interested in making or taking delivery. The real challenge for traders is to take price information and make sense of it—to convert it to dollar terms and understand the extent of profit or loss. This task is surprisingly easy to accomplish once you understand how prices and contracts are configured.

NOTE

Trading parameters are subject to change without notice. Always be aware of that possibility and confirm with the clearing firm or exchange before trading.

Tick Size

Each futures contract has a minimum price increment, called its tick size (refer to Figure 3-2).

Figure 3-1a *Contract size*

PRECIOUS METALS

	GOLD	(CMX)	-	100	troy	oz.-	dollars	per	troy	oz.
	329.00	262.10	Oct 00	16	269.10	270.10	269.10	270.10	+	0.80
	276.60	270.80	Nov 00	2	270.80	271.40	270.80	271.40	+	0.80
★	**474.50**	**261.70**	**Dec 00**	**85,213**	**272.00**	**273.20**	**272.00**	**272.90**	**+**	**0.80**
	333.00	265.40	Feb 01	15,285	275.00	275.80	274.60	275.60	+	0.80
	308.30	277.20	Apr 01	4,237	...	...	...	278.20	+	0.80
	447.00	267.10	Jun 01	8,713	281.00	281.60	280.70	280.70	+	0.80
	328.50	282.80	Aug 01	2,424			...	283.20	+	0.80
	314.80	305.50	Oct 01	523	...	...	...	285.50	+	0.80
	429.50	266.80	Dec 01	4,536	288.00	288.00	287.90	287.90	+	0.80
	309.30	309.30	Feb 02	10			...	290.20	+	0.80
	316.20	316.20	Apr 02				...	292.50	+	0.80
	385.00	304.50	Jun 02	3,199			...	294.80	+	0.80
	297.60	297.60	Aug 02				...	297.20	+	0.80
	358.00	284.00	Dec 02	1,433			...	301.90	+	0.80
	344.80	296.30	Jun 03	949			...	309.10	+	0.80
	359.30	299.40	Dec 03	1,549			...	316.30	+	0.80
	357.00	325.50	Jun 04	1,459			...	323.50	+	0.80
	388.00	329.80	Dec 04	825			...	330.60	+	0.80
	359.20	347.50	Jun 05		...	...	...	337.90	+	0.80

★ ***Gold Comex Exchange Contract size – 100 troy ounces Priced in dollars per ounce. December contract closed at 272.90 up $ 0.80 or 80 cents Contract Value = $272.90/oz × 100 oz = $27,290 Net Change Value = $0.80/oz × 100 oz = $80 Minimum tick size = $0.10/oz or 10 cents/oz Value of one tick = 100oz × $0.10/oz = $10.***

For example, corn futures have a tick size of one-fourth cent. This information is readily available. You can easily calculate the dollar value of each tick by multiplying the contract size by the tick size:

dollar value per tick = contract size × tick size

So, we have 5,000 bushels × (cent/bushel ($.25/bu.) = $12.50 per tick.

You can perform this calculation again and again, and it is the same formula for every market. Although the prices of futures contracts can change daily and can be different from delivery month to delivery month, the value of each tick remains the same.

Figure 3-1b *Contract size*

*	UNLEADED GASOLINE (NYM)			-	42,000	gal.	cents
	97.70	59.28	Nov 00	30,054	84.50	87.20	84.50	86.91
	95.00	58.58	Dec 00	12,674	85.60	88.60	84.00	85.87
	93.50	58.38	Jan 01	5,755	84.25	85.40	84.25	85.17
	92.55	63.68	Feb 01	5,655			...	85.42
	90.90	65.28	Mar 01	4,602	...	...	...	86.12
	96.50	68.25	Apr 01	5,602	89.60	91.22	89.60	91.22
	93.90	69.80	May 01	3,802				90.57
	92.75	74.90	Jun 01	2,309			...	89.37
	90.25	75.57	Jul 01	931			...	87.77
	86.00	75.44	Aug 01	4,666			...	86.12
	82.80	80.60	Sep 01	1,294			...	84.02
	79.76	79.76	Oct 01	1	...	...	...	80.42

**Unleaded Gasoline NY Mercantile Exchange Contract size = $42,000 gallons Priced in cents per gallon November Contract closed at 86.91 or 86.91 cents/gallon Contract Value = $.8691/gallon × 42,000 gallons = $36,502.20 Minimum tick size = .01 cents/gallon Value of one tick = .01 cents/ gallon x 42,000 gallons or $.001/gallon × 42,000 = $4.20.*

Limit Moves

Markets, especially those that are thinly traded, have the capability to lock limit. Each exchange sets trading parameters for its products. The exchange sets the range within which the market can trade during a single session. The primary purpose is to keep market fluctuations from getting out of hand. If a rumor of bad news hits the market and there are no limits, the prices could drop dramatically before everyone has a chance to assess the situation. Considerable price damage could occur even with the possibility that the rumor was untrue. Limits are designed to give the market a breather before trading resumes.

For example, pork bellies are currently only allowed to fluctuate between 3 cents per pound higher and 3 cents per pound lower from the closing price of the previous day. If market conditions are extreme (for example, a bearish supply report or news of disease), the market might drop the allotted 3 cents and then lock at that level. In other words, the outlook for pork prices is so weak that no willing buyers exist at the limit low of the day. The market might open at the limit and stay there throughout the trading day. Unless a buyer is willing to pay the limit price, a trade will not take place that day. Often, the exchange will expand the limit by 150 percent for trad-

Figure 3-2a *Tick size*

STOCK INDEXES

S&P COMP INDEX 250 x premium

Strike		Calls			Puts	
Price	Oct	Dec	Mar	Oct	Dec	Mar
1000	no tr	416.500	no tr	no tr	0.800	3.800
1025	391.500	no tr	no tr	0.100	1.000	4.600
1050	no tr	366.500	no tr	0.100	1.200	5.600
1075	no tr	no tr	no tr	0.100	1.600	6.700
1100	no tr	no tr	no tr	0.100	2.200	8.100
1125	no tr	no tr	no tr	0.150	3.000	9.800
1150	no tr	268.300	no tr	0.200	3.900	11.800
1175	no tr	no tr	no tr	0.300	5.100	14.300
1200	no tr	221.100	no tr	0.400	6.600	17.000
1225	no tr	no tr	no tr	0.550	8.500	20.300
1250	no tr	175.700	no tr	0.800	10.900	24.000
1275	no tr	no tr	no tr	1.300	13.900	28.300
1300	no tr	132.800	167.600	2.200	17.600	33.400
1320	no tr	no tr	no tr	3.200	21.200	37.900
1325	94.800	112.800	no tr	3.500	22.300	39.100
* 1350	72.100	93.700	131.100	5.700	28.000	45.800
1360	no tr	no tr	no tr	7.000	30.700	48.700
1375	no tr	76.100	no tr	9.600	35.100	53.400
1400	32.800	60.200	98.600	16.300	43.900	62.000
1405	29.500	57.300	no tr	18.000	45.900	no tr
1410	26.400	54.300	no tr	19.900	47.900	no tr
1415	23.500	51.500	no tr	22.000	50.000	no tr
1420	20.800	48.700	no tr	24.300	52.200	no tr

SP 500 Index options Chicago Mercantile Exchange Contract size $250 × Index option value $250 × premium quoted in number of Index points:

1) December 1350 call option closed at 93.700
Option value = 93.700 × $250 = $23,425

2) December 1350 put option closed at 28.000
Option value = 28.000 × $250 = $7,000

ing the next day in an attempt to keep the price fluctuations controlled, but the exchange will possibly widen them enough to stimulate trade.

NOTE

An important item to note about limit moves is that there is a possibility that stop orders will not be filled.

Figure 3-2b *Tick size*

STOCK INDEXES

WHEAT - 5,000 bu, cents per bushel

	Strike	Calls			Puts		
	Price	Dec	Mar	May	Dec	Mar	May
	280	38.750	0.125	no tr	.500	1.125	no tr
	290	29.875	no tr	no tr	1.625	3.125	5.500
	300	22.000	36.375	44.375	3.625	4.875	6.375
	310	15.375	29.750	37.625	7.250	8.125	9.500
*	320	10.375	24.125	31.875	12.250	12.375	13.500
	330	6.875	20.000	26.875	18.250	17.500	18.125
	340	5.000	15.750	22.500	no tr	23.825	23.625
	350	2.875	13.625	18.875	no tr	30.625	no tr
	360	1.875	10.625	15.875	51.250	6.000	no tr
	370	1.375	8.750	13.250	no tr	5.125	no tr
	380	0.875	7.625	11.125	no tr	54.500	no tr
	390	0.500	6.250	no op	no tr	3.625	no op
	400	0.375	5.375	8.125	no tr	3.125	no tr

Prev day Call Vol 1,720 Open int 14,963

Wheat options chicago board of trade contract size 5,000 bushels quoted in cents per bushel:

1) December 320 call option closed at 10.375 cents/bu Option value = 10.375 cents/bu × 5,000 bu or $.10375/ bu × 5,000 bu = $518.75

2) December 320 put option closed at 12.25 cents/bu Option value = 12.25 cents/bu × 5,000 bu or $.1225/ bu × 5,000 bu = $612.50

Example: Pork Belly Limit Move.[1] Let's say that pork bellies finished trading at 89 cents per pound. A trader is long in the market from 87 cents per pound with a good-until-canceled protective sell order at 86 cents per pound. The market had been trading higher recently, due to the anticipation of restricted supply down the road.

After the close, the *United States Department of Agriculture* (USDA) released the Cold Storage Report, which indicated a giant supply of frozen pork bellies—well beyond market expectations. Consequently, the price of 89 per pound is too high, given the actual supply conditions. The next day, pork bellies are likely to open limit down (86 cents per pound).

When a market opens limit down, we know that there were far more willing sellers on the open than there were buyers. Often, there were no

[1]Please refer to glossary in Chapter 2 for definitions.

buyers on the open; only people who were willing to sell. These sellers could either be trying to liquidate a long position or sell short a new position. Given the bearishness of the supply report, however, there were few (if any) people who were willing to buy pork bellies at 86 or higher. Consequently, the market does not trade.

Recall the trader who was long in pork bellies and had a sell stop at 87. (A sell stop is an order that instructs the floor broker to sell a certain number of contracts if the market trades at 87 or lower.) Without a willing buyer with which to trade, the broker cannot execute the order. The stop sits all day waiting to be filled.

The next question is, "How long will lock limit continue?" Even with expanded limits, the scenario might be bearish enough that pork bellies open at limit the next day and possibly the next day before the market trades low enough to entice buying.

You can often obtain an indication of how drastic the conditions are by getting what is called the pool of unfilled orders. Typically, the floor brokers have an idea of how many contracts they need to sell by examining their deck of orders. They add the number of sell orders, market orders, sell stops, sell limits, and so on and report the quantity to the exchange. Often, these numbers are reported on news wires or to brokerage firms. The greater the number of unfilled orders (the pool), the more likely the market is to lock limit the following day.

When will the sell stop at 87 be filled? Obviously, sell orders will not be filled until buyers enter the market. These buyers could either be initiating a position or offsetting a short position. Because the sell stop is an order to sell pork bellies at the first available price after the market trades at 87 or lower, the broker will execute the trade as soon as possible.

If there are 1,000 contracts in the pool of unfilled sell orders and an order to buy 100 contracts comes into the pit, obviously only 100 contracts will be bought. That will leave 900 contracts still left for sale. Although a market trades at the limit price, in extreme conditions it is possible that your order will not be filled.

You can imagine that many people are anxious to have their sell orders filled. The floor broker now needs to prioritize his or her orders to fill them as quickly as possible in case more buy orders come into the pit. Typically, these orders are prioritized by the date they were entered. Although not etched in stone, these orders are filled in order of size and date. Therefore, canceling your open order and entering a market order in the hopes of selling your contract faster is not a good idea. Rather, you should leave the order in place and be patient.

I must add that without order flow, the floor traders are not trading, either. They might or might not be stuck in a limit position, as well.

The market stays at limit all day. The exchange then announces that they are expanding the limit to 4.5 cents for the next day. In other words, pork bellies can now trade as low as 81.50 cents or as high as 90.50 cents (the closing price of 86 cents $\pm$ 4.5 cents).

The market opens at limit down again, and now there are 1,500 contracts to sell. There are now more stop orders below the close of 86 that

need to be filled. But at 81.50 cents, the prices are low enough to entice buyers into the pit. As the buy orders come in, at first they are only willing to buy at 81.50, due to the high level of emergency sell orders.

Finally, the sell stop order of 87 is filled at 81.50 cents per pound—5.5 cents lower than expected, or $2,200 per contract lower than anticipated.

Limit moves are usually unforeseen circumstances. You can limit these effects by following these simple rules:

1. Only trade in liquid markets.
2. Only trade with risk capital (money that you can afford to lose).
3. Keep open-order stops in place, and do not try to get fancy.
4. Understand the availability of option strategies that can dramatically limit the financial loss in a lock-limit scenario (refer to Chapter 8, "Options Trading").

Circuit Breakers

Another form of trading regulation is circuit breakers. Usually, circuit breakers apply to stock index futures. Again, to prevent market panic, the exchange sets levels at which trading is forced to pause for a period of time before it can resume, which gives the market a chance to catch its breath and digest the market information before continuing. Often, these circuit breakers are calculated as a percentage of the contract value. For example, trading in the Dow Jones Industrial Average futures might be halted for 10 minutes if the market drops 250 points or lower. After trading resumes, if the market drops to 400 points lower during the day, trading might again be halted for 30 minutes. The idea of circuit breakers is to give the market a chance to breathe without setting actual trading limits. The market can continue to trade lower as long as the stock exchanges are trading, as well. This system prevents extreme cash imbalances between stock index prices and stock index futures prices.

Currently, there are hard limits set on the GLOBEX session of stock index futures contracts. (GLOBEX is the off-hours electronic session for stock index futures, currencies, and other futures contracts.) These levels are determined by a certain percentage of contract value and can be contracted or expanded as ordered by the exchange. For example, in the Spring of 2000, the NASDAQ 100 futures contract locked limit in overnight trading at − 82 points. The exchange then expanded that limit to − 110 points for future sessions. Due to the relative illiquidity of stock index futures on the electronic market, the exchange must set firm limits to prevent market hysteria from prevailing before the cash stock market has a chance to open.

Margins

The exchange sets margins. A margin, by definition, is the minimum amount required on deposit to trade a particular futures contract. The exchange determines the margins based on the perceived risk of the trade. This risk is determined by contract size, value, and daily volatility.

To trade in the futures markets, traders must post a margin deposit in order to ensure performance against the obligations of the futures contract. The deposit is a small percentage of the contract value and is required to absorb price fluctuations of the contract.

The initial margin is the amount that must be on deposit in order to first place the order. Based on the closing prices, the account is then credited or debited each day that the position is maintained.

The maintenance margin is the minimum margin level that must be maintained in order to keep the position. If debits from market losses reduce your account below the maintenance level, the trader must either deposit enough funds to bring the equity value back up to the initial margin level or liquidate the position.

The margin call is the request for additional funds.

Example of a Margin Call Scenario: Gold.

Initial $1,000	A			E
$950			C	
$900		B		
Maintenance $800				
$700				D

Imagine that a trader plans to buy gold. The initial margin deposit required is $1,000. The maintenance margin requirement is $800 per contract. The trader deposits $1,000 into the futures account. He then places an order to buy one contract at $300 per ounce. The gold futures contract size is 100 ounces. Each dollar move in the price of gold is $100 ($1 × 100 ounces = $100).

A. The trader places a margin of $1,000 and buys one contract of gold at $300 per ounce.

B. The next day, gold closes down one dollar at $299. The margin account is debited $100 to reflect the loss on the contract. The account balance is $900.

C. The following day, gold closes 50 cents higher to $299.50. The account is credited $50 to reflect the gain (.50 × 100 ounces = $50). The account balance is $950.

D. Gold drops $2.50 the following day to $297 per ounce. The account is debited $250 to reflect the loss on the contract ($299.50 − 297 = $2.50 × $100 = $250). The account balance is now $700, which is $100 below the maintenance requirement of $800 per contract. The trader must now either liquidate the contract or deposit enough funds to bring the account balance back to the initial margin requirement of $1,000.

E. The trader chooses to deposit the money. He or she adds $300 to the account in order to keep the position.

You should consider several important points with respect to margin calls:

1. Because margins represent a small portion of your total market exposure, futures positions are considered highly leveraged transactions.
2. Margin calls usually must be met by deposit (cashiers check or wire transfer) or liquidation by the close of the trading day.
3. A brokerage firm reserves the right to liquidate positions in a margin call situation if the client is either unreachable or unwilling to meet the margin call.
4. If normal price fluctuations are causing repeated margin calls, the account is over-leveraged and the trading size should be cut down.
5. Margin calls are given during intra-day trading as well—not necessarily the market value at the close. A position can be liquidated at any time during the trading day.
6. Margin calls usually mean that the position is on the wrong side of the market.
7. Successful traders trade with considerable margin and a sound trading plan. More often than not, margin calls will not occur if a trader exercises solid risk-management techniques.
8. When making margin calls, the broker should keep accurate records of the time of conversation, tape the conversation, and keep careful notes. There are usually strict house rules to follow when making margin calls. A broker should follow them to the letter.
9. Often, due to the emotional link to a position, speculators will hide from margin calls. Traders often hope that the market will turn around and refuse to liquidate the trade. Sometimes, when faced with a margin call, traders might pretend they are not home, refuse to answer the phone, lie about sending the money, and so on in order to avoid taking the loss. In this situation, the broker must take control and execute his or her right to protect the firm's assets by liquidating the position—with or without the client's consent. At this time, the broker needs to distance himself or herself from the personal relationship and react accordingly.

10. The trader will often then blame the broker for the loss due to margin liquidation—even if it was his or her own trade. This situation illustrates a deep-seeded need to defer the responsibility of the loss to another party. Really, the trader is at fault for ignoring the position and/or trading with too little capital. Human nature, however, makes it difficult to accept responsibility for our own mistakes.
11. Disputes often occur in a margin-liquidation scenario for the reasons mentioned earlier. If a broker takes good notes, acts responsibly, and follows procedures, the decision will always land in the favor of the broker and clearing firm. Even if the market ends up coming all the way back to a level where the client would have been profitable, if the account was under-margined at any time during the trade, then the broker has the right to liquidate the position.
12. Margins are set by the exchange, but a clearing firm or brokerage house can charge the margin above that level as deemed appropriate. A broker can also refuse to accept an order from a client if he or she determines the trade to be too risky for the account size.
13. Margins are subject to change without notice.
14. If you have multiple positions, the margin requirements are totaled to get the total initial and total maintenance levels.

Multiple Futures Positions: Calculating Margin

With respect to number 14 in the previous list, consider the following scenario. If you have three different futures positions—one corn, one cattle, and one oats—you need to add them all together to get the initial margin requirement. Assume that corn is $500, cattle is $800, and oats is $600. The total initial requirement is then $1,900. Assume that the maintenance for corn is $300, the maintenance for cattle is $600, and the maintenance for oats is $400. That makes the total maintenance margin level $1,300.

Profit and losses in the account are now tabulated on each commodity and are added together to get the account balance. Let's consider the following scenario:

Initial $1,900	A	
		E
$1,750		C
$1,600	B	
Maintenance $1,300		
$1,000		D

A. Assume that you had exactly $1,900 in your account and you bought one contract of corn, one contract of cattle, and one contract of sugar. You would have the exact margin amount.

B. The next day, corn is unchanged, cattle loses $200 (one half of a cent per pound), and the oats contract loses $100 (2 cents per bushel). Your new account balance at the close of the day would be $1,600, which is still within the margin limits.

C. The next day, corn loses $100 (2 cents per bushel), but cattle gains $200 (one half cent per pound) and oats rise another $150 (3 cents per bushel). Your account balance rises to $1,750.

D. The next day, all three contracts fall in price. Cattle loses $600[2]; corn loses $50; and oats gives back $100. Your account balance has now fallen to $1,000, which is too low to hold all three contracts.

E. You have the choice of adding $900 to bring the entire balance back to $1,900, or you could liquidate one or two of the positions. Some brokers will allow you to add between $300 and $900 to bring your balance above the maintenance level. The downside to this, however, is that your account is still trading very close to a margin call and is over-leveraged.

Margin calls with multiple positions become tricky. If you liquidate the cattle position, you now eliminate the need for $800 in initial margin. So now, out of the $1,000 you have in your account, you only need to margin two positions: corn and oats. The total initial margin requirement for the two is $1,100. The maintenance level is only $700, so according to the model, your account is no longer under-margined. The down side is, of course, that you are still trading with limited funds, and your account could easily go on call again. When trading with multiple positions, you should always consider the following factors:

1. Margin requirements are cumulative. Always be certain that you have trading capital that exceeds the minimum requirements.
2. Margin calls in this situation force you to choose between contracts to liquidate. Often, the choice will be to liquidate the one with the larger margin requirement, which might prove to be the wrong choice.
3. Margin calls force you to change your trading plan and ultimately can lead to losses.
4. Stop loss orders designed to help limit risk could have helped avoid this situation.
5. Profits on a trade add to the account balance, whereas losses on a trade take away from the account balance.
6. Sometimes margin calls will entice you to keep the trade that is winning over those that might be losing at the time. Again, this decision might not concur with your original trading plan. Trading decisions should be based on the price action of the market, not on the profit or losses of different contracts at different periods of time.

[2]A limit move for cattle

7. Choosing to exit cattle because you desire to keep corn is not a structured trading decision and is likely to be a losing proposition over time.
8. Avoid having to make these decisions by keeping your account properly margined at all times.

Margin protocol is important because of the personal attachment that traders have to their positions and their money. You should note that margins exist for a reason. They are designed to protect all participants from excessive financial loss. Do not trade in markets that are too risky for your current financial condition. Success in the markets comes from steady growth and consistent discipline. Success is more likely if traders have respect for the leverage that futures trading provides.

How to Read Futures Prices[3]

Many firms provide contract specifications and many books discuss basic terminology, but few teach you how to interpret the prices that you see. How do you take the price that you see and convert it into dollars and cents? Many markets have similar contract sizes and calculation techniques. The following text shows some helpful hints on how to interpret prices in the newspaper as well as on your trading screen.

Grains.

CBOT Wheat.

5,000 bushels per contract. Minimum price fluctuation 1/4 cent.
Each 1/4 cent move = 5,000 bu. × 1/4 cent/bu. = $12.50 per tick
Each full penny move is 4, 1/4 cent moves or ($12.50 × 4) = $50/bu.
First limit move is 20 cents.

KCBOT Wheat.

5,000 bushels per contract. Minimum price fluctuation 1/4 cent.
Each 1/4 cent move = 5,000 bu. × 1/4 cent/bu. = $12.50 per tick
Each full penny move is 4, 1/4 cent moves or ($12.50 × 4) = $50/bu.
First limit move is 20 cents.

CBOT Corn.

5,000 bushels per contract. Minimum price fluctuation 1/4 cent.
Each 1/4 cent move = 5,000 bu. × 1/4 cent/bu. = $12.50 per tick
Each full penny move is 4, 1/4 cent moves or ($12.50 × 4) = $50/bu.
First limit move is 12 cents.

[3]What follows are the most current contract specifications available upon the writing of this book. Contract specifications and margin requirements are subject to change at any time.

CBOT Oats.

5,000 bushels per contract. Minimum price fluctuation 1/4 cent.
Each 1/4 cent move = 5,000 bu. × 1/4 cent/bu. = $12.50 per tick
Each full penny move is 4, 1/4 cent moves or ($12.50 × 4) = $50/bu.
First limit move is 10 cents.

CBOT Soybeans.

5,000 bushels per contract. Minimum price fluctuation 1/4 cent.
Each 1/4 cent move = 5,000 bu. × 1/4 cent/bu. = $12.50 per tick
Each full penny move is 4, 1/4 cent moves or ($12.50 × 4) = $50/bu.
First limit move is 30 cents.

Many products have similar pricing structures. Therefore, there are consistent patterns for determining contract value. Other products are listed with the same number of digits but are quoted in an entirely different manner. The following are some clues to quoting various commodities:

Grain Products. For grain products that are priced in bushels (where the contract size is 5,000 bu.), a one-cent move will always be worth $50.[4]

In the newspaper, the price fluctuation is listed in fractions. On electronic quote screens, however, the denominator is often dropped off. For example, in the newspaper, a 1/4-cent move higher is listed as + 1/4. On a quote screen, however, a quarter cent move higher is often listed as +2.

For example, corn priced at 234 1/4 might be listed on a quote screen as 2342. The right-hand digit is assumed to always represent the fraction. In this situation, the fraction is in eighths. 2/8 = 1/4.

If corn closed at 234 on Monday and then closed at the following prices on Tuesday, the difference in quotes would look similar to the following:

Screen	Net Change or Paper		Net Change	Value
2342	+ 2	234 1/4	+ 1/4	$12.50
2344	+ 4	234 1/2	+ 1/2	$25
2346	+ 6	234 3/4	+ 3/4	$37.50
2350	+ 10*	235	+ 1	$50

*One cent is listed as 10 (as one and zero eighths).

2350 is quoted as "2 dollars and 35 cents per bushel," or "two-thirty-five."

[4]Often, quote services and newspapers vary in the way these prices are displayed.

CBOT Soybean Oil.

Contract size is 60,000 lbs. Minimum price fluctuation is .01 cent per pound ($.01).

Each one cent move = 60,000 lbs. × $.01 per lb. = $6 per tick.

One point move ($1.00 move) = $600

First limit move is $1.00.

The quote screen might or might not use decimals. Assume that the last two digits are the cents.

If soybean oil closed Monday at 17.39 and Tuesday closed higher, Tuesday quotes might look like the following:

Screen	Net Change or Paper		Net Change	Value
1740	+1	17.40	+.01	$6
1741	+2	17.41	+.02	$12
(Big Jump)				
1839	+100	18.39	+1.00	$600

Soybean oil is quoted as "17 dollars and 40 cents per pound," or "seventeen-forty."

CBOT Soybean Meal.

Contract size is 100 short tons. Minimum price fluctuation is .10 cents per ton ($.10).

Each 10 cent move = 100 tons × $.10 / ton = $10 per tick

One full point move or $1.00 move = $100

First limit move is $10.00.

A quote screen might or might not use decimals. Because soybean meal trades in 10-cent increments, often the last digit is dropped (always assumed to be zero). For example, say soybean meal closed at 170 on Monday and finished higher on Tuesday, the prices might be quoted as follows:

Screen	Net Change or Paper		Net Change	Value
1701	+1	170.10	+.10	$10
1702	+2	170.20	+.20	$20
1710	+10	171.00	+1.00	$100

Soybean meal is quoted as "170 dollars and 10 cents per ton," or "one-seventy-ten."

Meats.

CME Live Cattle.

Contract size 40,000 lbs. Minimum price fluctuation is .025 cents ($.00025).

Each .025 cent move = 40,000 lbs. × $.00025 = $10 per tick

One full cent move ($.01) or a one point move = $400

First limit move is 1½ cents.

Often, the last digit of the price of cattle is dropped. For example, if cattle is trading at 69.42 ½ cents per pound, the quote screen might list it as 6942 and assume the ½ to be true.

Say that cattle closed Monday at 69.40. Prices might look like the following on Tuesday:

Screen	Net Change	Paper	Net Change	Value
6942	+2	69.42 ½	+2 ½	$10
6945	+5	69.45 ½	+5	$20
6947	+7	69.47 ½	+7 ½	$30
6950	+10	69.50	+10	$40
or				
7040	+100	70.40	+1.00	$400

Always assume that the ½ is true.

Quote live cattle prices as follows: "69 point 50 cents per pound," or "69 – 50 per pound" or "Cattle is trading at sixty-nine-fifty."

CME Feeder Cattle.

Contract size 50,000 lbs. Minimum price increment is .025 cents per pound ($.00025).

Each .025 cent move = 50,000 lbs. × $.00025 = $12.50 per tick

One full cent move (one point move) = $500

First limit move is 1 ½ cents.

The last digit of the price of feeder cattle is dropped. For example, if feeders are trading at 79.42 ½ cents per pound, the quote screen might list it as 7942 and assume the ½ to be true.

Say that feeder cattle closed Monday at 79.40. Prices might look like the following on Tuesday:

Screen	Net Change	Paper	Net Change	Value
7942	+2	79.42 1/2	+2 1/2	$12.50
7945	+5	79.45 1/2	+5	$25
7947	+7	79.47 1/2	+7 1/2	$37.50
7950	+10	79.50	+10	$50
or				
8040	+100	80.40	+1.00	$500

Always assume that the 1/2 exists.

Quote feeder cattle prices as follows: "79 point 50 cents per pound," or "79 – 50 per pound," or "Feeders are trading at seventy-nine-fifty."

CME Lean Hogs.

Contract size 40,000 lbs. Minimum price fluctuation is .025 cents per pound ($.00025).

Each .025 cent move = 40,000 lbs × $.025 = $10 per tick

One full cent move (1.00 cents or one point) = $400

First limit move is 2 full cents.

The last digit of the price of hogs is dropped. For example, if hogs are trading at 49.42 1/2 cents per pound, the quote screen might list it as 4942 and assume the 1/2 to be true.

Say that hogs closed Monday at 49.40. Prices might look like the following on Tuesday:

Screen	Net Change	Paper	Net Change	Value
4942	+2	49.42 1/2	+2 1/2	$10
4945	+5	49.45	+5	$20
4947	+7	49.47 1/2	+7 1/2	$30
4950	+10	49.50	+10	$40
or				
5040	+100	50.40	+100	$400

Always assume that the 1/2 is present.

Quote lean hog prices as follows: "49 point 50 cents per pound," or "49 – 50 per pound," or "Hogs are trading at forty-nine-fifty."

CME Pork Bellies.

Contract size 40,000 lbs. Minimum price fluctuation is .025 cents per pound ($.00025).

Each .025 cent move = 40,000 lbs. × $.025 = $10 per tick

One full cent move (1.00 cents or one point) = $400

First limit move is 3 full cents.

The last digit of the price of pork bellies is dropped. For example, if bellies are trading at 89.42 ½ cents per pound, the quote screen might list it as 8942 and assume the ½ to be true.

Say that bellies closed Monday at 89.40. Prices might look like the following on Tuesday:

Screen	Net Change	Paper	Net Change	Value
8942	+2	89.42 ½	+2 ½	$10
8945	+5	89.45	+5	$20
8947	+7	89.47 ½	+7 ½	$30
8950	+10	89.50	+10	$40
or				
9040	+100	90.40	+1.00	$400

Always assume that the ½ is present.

Quote pork belly prices as follows: "89 point 50 cents per pound," or "89 – 50 per pound," or "Bellies are trading at eighty-nine-fifty."

Foods.

CSC World Sugar #11.

Contract size 112,000 lbs. Minimum price fluctuation is .01 cent ($.0001).

Each .01 cent move = 112,000 lbs. × $.0001 = $11.20 per tick

One full point move (one cent or $.01) = $1,125

Sugar is quoted in cents per pound. If sugar closed at 5.30 cents per pound on Monday, Tuesday's trading might look like the following:

Screen	Net Change	Paper	Net Change	Value
531	+1	5.31	+.01	$11.20
532	+1	5.32	+.02	$22.40
or				
630	+100	6.30	+1.00	$1,120

Quote sugar as follows: "Sugar is trading at 5 point 31 cents per pound," or "Sugar is trading at five-thirty-one."

CSC Coffee.

Contract size 37,500 lbs. Minimum price fluctuation is .05 cents ($.0005).
Each .05 cent move = 37,500 lbs. × $.0005 = $18.75
One full cent or one point move = 37,500 lbs. × $.01 = $375
First limit move is .05 cents per pound.

Coffee is quoted in cents per pound. If coffee closed on Monday at 99.00, Tuesday's trading might look like the following:

Screen	Net Change	Paper	Net Change	Value
9905	+5	99.05	+.05	$18.75
9910	+10	99.10	+.10	$37.50
or				
10000	+100	100.10	+1.00	$375

Quote coffee as follows: "Coffee is trading at ninety-nine-ten." If coffee is trading above a dollar a pound (as it often can), then the price will look like 100.10. Quote it as "one dollar point ten." If coffee is at 102.00, quote it as "Coffee is trading at one dollar and two cents per pound."

CSC Cocoa.

Contract size 10 metric tons. Minimum price fluctuation is $1 per ton.
Each one dollar move = 10 tons × $1 per ton = $10.
One point and one tick are the same with cocoa.
First limit move is $150 per ton.

If cocoa closed at 800 on Monday, Tuesday's trading might look like the following:

Screen	Net Change	Paper	Net Change	Value
801	+1	801	+1	$10
802	+2	802	+2	$20
or (big jump)				
900	+100	900	+100	$1,000

Cocoa is quoted as "800 and one dollars per ton," or "Cocoa is trading at eight-oh-one."

CTN Orange Juice.

Contact size 15,000 lbs. Minimum price fluctuation is .05 cents ($.0005).
Each .05 cent move = $.0005 × 15,000 = $7.50 per tick
One point is one cent or $.01 × 15,000 = $150
First limit move is 20 cents.

Frozen concentrated orange juice is quoted in cents per pound. Say that orange juice closed at 82.50 cents on Monday. Tuesday's trading might look like the following:

Screen	Net Change	Paper	Net Change	Value
8255	+5	82.55	+.05	$7.50
8260	+10	82.60	+.10	$15.00
or				
8350	+100	83.50	+1.00	$150

Orange juice is quoted in cents per pound. Quote the price as follows: "Orange juice is trading at 82 point 50 cents per pound," or "Orange juice is at eighty-two-fifty."

Metals.

CMX Silver.

Contract size 5,000 ounces. Minimum price fluctuation is .05 cents per ounce ($.005 per ounce).
Each half cent move = 5,000 ounces × $.005 = $25
One point move is $1.00 per ounce × 5,000 = $5,000
First Limit move is $2.50 per ounce.

Say that silver closed at $5.05 an ounce on Monday. Tuesday's prices might look like the following:

Screen	Net Change	Paper	Net Change	Value
5055	+5	5.055	+.005	$25
5060	+10	5.06	+.010	$50
or				
5150	+100	5.15	+.10	$500

Quote silver in dollars per ounce: "Silver is trading at 5 dollars and 5 cents per ounce," or "Silver is at five-oh-five."

Although silver trades in .005 increments, it often settles on different numbers. Although you cannot place a trade at anything other than 5150 or 5155 (and so on), silver can settle at 5158 (a computer-generated settlement, not a valid price).

CMX Gold.

Contract size 100 troy ounces. Minimum price fluctuation is .10 cents per ounce ($.10).

Each ten cent move = $.10 × 100 ounces = $10 per tick.

One point move is $1.00 per ounce × 100 ounces = $100

First limit move is $25 per ounce.

Say that gold closed Monday at $300 per ounce. Tuesday's prices might look like the following:

Screen	Net Change	Paper	Net Change	Value
3001	+1	300.10	+.10	$10
3002	+2	300.20	+.20	$20
3010	+10	301.00	+1.00	$100
or (big jump)				
3100	+100	310.00	+1.00	$1,000

Gold trades in dimes, so the last digit is often dropped on computer screens. Quote gold at 310.50 as "Gold is trading at three hundred ten dollars and fifty cents per ounce," or "Gold is at three-ten-fifty."

NYM Platinum.

Contract size 50 troy ounces. Minimum price fluctuation is .10 cents per ounce ($.10).

Each ten cent move = 50 ounces × $.10 = $5

One point of $1.00 × 50 ounces = $50.

First limit move is $50 per ounce ($2,500)

Typical margin requirement = $1,500

Say that platinum closed at $470.00 on Monday. Tuesday prices might look like the following:

Screen	Net Change	Paper	Net Change	Value
4701	+1	470.10	+.10	$5
4702	+2	470.20	+.20	$10
4710	+10	471.00	+1.00	$50
or (big jump)				
4800	+100	480.00	+1.00	$500

Platinum should be quoted in dollars per ounce. 471.00 should be quoted as "four hundred and seventy one dollar per ounce," or "Platinum is trading at four-seventy-one."

CMX Copper.

Contract size is 25,000 lbs. Minimum price fluctuation is .05 cents per pound ($.0005).

Each .05 cent = 25,000 × $.0005 = $12.50 per tick

One full penny move (one point) = $.01 × 25,000 = $250

First limit move is 20 cents ($5,000)

Typical margin requirement $1,300

Say that copper closed at 81.00 cents per pound on Monday. Tuesday might look like the following:

Screen	Net Change	Paper	Net Change	Value
8105	+5	81.05	+.05	$12.50
8110	+10	81.10	+.10	$25.00
or				
8200	+100	82.00	+1.00	$250

You should quote copper in cents per pound. Quote 8105 as follows: "81 point 05 cents per pound," or "Copper is trading at eighty-one-oh-five."

Energy.

NYM Crude Oil.

Contact size 1,000 barrels. Minimum price fluctuation is .01 cent ($.01).

Each one cent move = 1,000 barrel × $.01 = $10 per tick

One point move is $1.00 per barrel or $1,000.

First limit move $7.50 per barrel ($7,500)

Typical margin requirement: $3,400

Say that crude oil closed at $20.00 per barrel on Monday. Tuesday might look like the following:

Screen	Net Change	Paper	Net Change	Value
2001	+1	20.01	+.01	$10
2002	+2	20.02	+.02	$20
2010	+10	20.10	+.10	$100
or (big move)				
2100	+100	21.00	+1.00	$1,000

Crude oil is quoted in dollars per barrel. You should quote 20.02 as, "Twenty dollars and two cents per barrel," or "Crude is trading at twenty-oh-two."

NYM Heating Oil.

Contract size is 42,000 gallons. Minimum price fluctuation is .01 cents or $.0001.

Each .01 cent move = $.0001 × 42,000 = $4.20 per tick

One point is one cent per gallon = $.01 × 42,000 = $420

First limit move is 20 cents ($8,400)

Typical margin is $1,600

Heating oil closed at 70.00 cents to the gallon on Monday. Tuesday's prices might look like the following:

Screen	Net Change	Paper	Net Change	Value
7001	+1	70.01	+.01	$4.20
7002	+2	70.02	+.02	$8.40
or				
7100	+100	71.00	+1.00	$420

Quote heating oil in cents per gallon. Quote 70.02 as follows: "Seventy point oh-two cents per gallon," or "Heating oil is trading at seventy-oh-two."

NYM Unleaded Gasoline.

Contract size 42,000 gallons. Minimum price fluctuation is .01 cents per gallon ($.0001).

Each tenth of a cent move = $.0001 × 42,000 = $4.20

One full point is one cent = $.01 × 42,000 = $420

First limit move is 20 cents per gallon ($8,400)

Typical margin requirement: $1,600

Say that unleaded gas closed at 90.00 cents per gallon on Monday. Tuesday's prices might look like the following:

Screen	Net Change	Paper	Net Change	Value
9001	+1	90.01	+.01	$4.20
9002	+2	90.02	+.02	$8.20
or				
9100	+100	91.00	+1.00	$420

Quote unleaded gas in cents per gallon. Quote 90.02 as "Ninety-one point-oh-two per gallon," or "Unleaded gas is trading at ninety-oh-two."

Fiber.

CTN Cotton.

Contract size 50,000 lbs. Minimum price fluctuation is .01 cents per pound ($.0001).

Each .01 cent move = 50,000 × ($.0001) = $5

One full cent is one point = 50,000 × $.01 = $500

First limit move: 3 cents ($1500)

Typical margin requirement: $1,000

Cotton is priced in cents per pound. If cotton closed at 58.00 cents per pound on Monday, Tuesday might look like the following:

Screen	Net Change	Paper	Net Change	Value
5801	+1	58.01	+.01	$5
5802	+2	58.02	+.02	$10
or				
5900	+100	59.00	+1.00	$500

If cotton is at 59.02, you should quote it as "Fifty nine point oh-two cents per pound," or "Cotton is trading at fifty-nine-oh-two."

Stock Indices.

CME S&P 500 Index.

Contract size: 500 × Index value. Minimum price fluctuation is .10 cents.

Each .10 cent move = $250 × .10 = $25

One point is 1.00 move = $250 × 1.00 = $250

First limit move is calculated on a percentage of contract-value basis and market hits circuit breakers throughout the day to slow trading (the first breaker is currently at 45 points, or $11,250).

On the GLOBEX session (off-hours), the S&P has a limit move of 35 points, and if locked-limit, it does not resume trading until the open outcry begins.

Typical margin requirement $20,000 (has been as low as $9,000)

If the SP500 closed at 1,500 on Monday, Tuesday might look like the following:

Screen	Net Change	Paper	Net Change	Value
15001	+10	1,500.10	+.10	$25
15002	+20	1,500.20	+.20	$50
or				
15010	+100	1,501.00	+1.00	$250

S&P 500 is a large contract that moves quickly and is quoted as an index, not as a price value. If S&P 500 were trading at 1555.00, it would be quoted as "Fifteen hundred fifty five even." Or, we would say, "The S and P is trading at fifteen-fifty-five even."

GLOBEX Mini-S&P 500.

Contract size: $50 times the index. Minimum price fluctuation is .25 cents.

A .25 cent move = .25 × $50 = $12.50

One point move is 1.00 × $50 = $50

Limit move is calculated on a percentage basis.

Margin requirement typically $5,000

Mini-S&P (E-mini) closes at 1,500.00 on Monday. Tuesday might look like the following:

Screen	Net Change	Paper	Net Change	Value
150025	+25	1,500.25	+.25	$12.50
150050	+50	1,500.50	+.50	$25
or				
150200	+200	1,502.00	+2.00	$100

If the E-mini S&P is trading at 1,555.50, it should be quoted as "Fifteen-fifty-five-fifty."

GLOBEX Mini-NASDAQ.

Contract size: $20 times the index. Minimum price fluctuation is .50 cents.

A price move of .5 = $20 × .5 = $10 per tick.

One point move is 1.0 × $20 = $20.

The limit move varies on percentages but could be around 400 points ($8,000).

Typical margin requirement: $6,000

If the mini-NASDAQ closed at 4,800 on Monday, Tuesday might look like the following:

Screen	Net Change	Paper	Net Change	Value
48005	+5	4,800.50	+.50	$10
48010	+10	4,801.00	+1.00	$20
or				
48500	+500	4,850.00	+50.00	$1,000

Quote the mini-NASDAQ as an index value, not as a dollar price. You should quote 4,800 as "four thousand eight hundred," or "The mini-NASDAQ is at forty-eight-hundred even."

CBOT Dow Jones Industrial Average.

Contract size: $10 times the index. Minimum price fluctuation is 1.

Each one tick move = 1 × $10 = $10

Limit move varies as a percentage, could be around 500 points ($5,000)

Margin requirement is typically $6,700.

If the Dow Jones futures contract closed at 11,300 on Monday, Tuesday might look like the following:

Screen	Net Change	Paper	Net Change	Value
11301	+1	11,301	+1	$10
11302	+2	11,302	+2	$20
or				
11400	+100	11,400	+100	$1,000

The Dow should be quoted as an index, not as a dollar value. You should quote 11,300 as "eleven thousand three hundred."

Financials.

CBOT 10-Year Treasury Note.

Contract size: $100,000. Minimum price fluctuation is $^1/_{64}$th of one percentage point (.01 / 64).

Value of one tick = (.01 / 64) × $100,000 = $15.625

One point = One whole percent ($^{64}/_{64}$ths) of contract size =.01 × $100,000 = $1,000

First limit move: 3 points ($3,000)

Typical margin requirement: $1,620

Treasury notes used to trade in 32nds. In 1999, they adopted the half tick as the new minimum price increment, which was actually one half of a 32nd (which is a 64th). On the quote boards, however, it shows up as "5" to represent the half tick.

Moving from right to left: The right-most digit represents the half tick. The next two digits represent the number of 32nds, and the final left-most digits represent whole numbers.

If the T-notes closed at 96-00 on Monday, price action on Tuesday might look like the following:

Screen	Net Change	Paper	Net Change	Value
96005	+5	96-005	+	$15.625
96010	+10	96-01	+1	$32.25
96100	+100	96-10	+10	$31.25

Quote the T-notes as a fraction. For example, 96-22 is quoted as "Ninety-six and twenty-two thirty-seconds," or 96-225 could be quoted as "ninety six, twenty-two and a half." If the notes are trading over par or above 100-00, then they are quoted in a slightly different manner. If the notes are trading at 101-20, say "T-notes are trading at one-oh-one twenty," or "one-oh-one and twenty 32nds."

CBOT 30-Year Treasury Bonds.

Contract size $100,000. Minimum price fluctuation is $^1/_{32}$nd of one percent ($.^{01}/_{32}$).

Tick value: $100,000 × ($.^{01}/_{32}$) = $31.25

Point size = One percentage point. .01 × $100,000 = $1,000

Limit move is 3 points: ($3,000)

Typical margin requirement: $2,500

T-bonds are quoted as fractions. Say that the bonds closed at 94-00 on Monday. Tuesday might look like the following:

Screen	Net Change	Paper	Net Change	Value
9401	+01	94-01	+01	$31.25
9402	+02	94-02	+02	$62.50
or				
9420	+20	94-20	+20	$625

Bonds are quoted as fractions. 96-22 is quoted as "ninety-six and twenty-two thirty-seconds," or "Bonds are trading at ninety-six twenty-two."

Currencies.

Japanese Yen.

Contract size 12,500,000 yen. Each tick is .01 cents per 100 yen ($\$.^{0001}/_{100}$) or ($.000001).

Value of one tick = $.000001 × 12,500,000 = $12.50

Point move is one full cent per 100 yen or ($\$.^{01}/_{100}$) or $.0001 × 12,500,000 = $1,250.

Limit move: 4 full cents per 100 yen or $.0004 × 12,500,000 or $5,000.

Typical margin requirement: $2,800

Yen is quoted in dollars per yen. If the yen futures were to close at 94.80 on Monday, Tuesday might look like the following:

Screen	Net Change	Paper	Net Change	Value
9481	+1	.9481	+.0001	$12.50
9482	+2	.9482	+.0002	$25
or				
9580	+100	.9580	+.0100	$1,250

The yen is easier to quote than it looks. A yen trade at 9480 is quoted, "The yen is trading at ninety-four eighty."

CME Euro Currency.

Contract size 125,000 Euros. Minimum price fluctuation is $.0001 per Euro. Always quoted in dollars per Euro.

Tick value = $.0001 × 125,000 = $12.50 = one point

First limit move: 800 points or .0800 × 125,000 = $10,000

Typical margin requirement: $2,400

If the Euro closed at .9800 on Monday, Tuesday might look like the following:

Screen	Net Change	Paper	Net Change	Value
9801	+1	.9801	+.0001	$12.50
9802	+2	.9802	+.0002	$25
or				
9900	+100	.9900	+.0100	$1,250

Quote the Euro as "The Euro is trading at ninety-nine even."

CME British Pound.

Contract size: 62,500 Sterling. Minimum price fluctuation is .02 cents to the pound. ($.0002).

Tick value is $.0002 × 62,500 = $12.50

One point is 50 ticks or 50 × .0002 = $.01 × 62,500 = $625

Limit move is 400 ticks or 400 × .0002 = $.08 × 62,500 = $5,000

Typical margin requirement: $1,600

The British pound is quoted in cents per pound. If the pound closed at 159.00 on Monday, Tuesday might look like the following:

Screen	Net Change	Paper	Net Change	Value
15902	+02	.15902	+.00002	$12.50
15904	+04	.15904	+.00004	$25
or				
16000	+100	.16000	+.00100	$1,250

159.80 is quoted as "One fifty-nine eighty." Remember that the British pound trades in twos. An order cannot be placed, for example, to buy one contract of the June British pound at 159.01 or 159.53. The last digit can only be an even number (for example, 159.00, 159.02, 159.04, and so on).

Day Session versus Night Session

There are major discrepancies between newspapers and computer programs with regard to how each system treats the night session trading. Because many actively traded commodities also trade on an overnight electronic market, there is often confusion between what the open, high, low, and close were for the night session and what they were for the day session. Some software or data services will combine all overnight sessions into one daily price.[5] This system can be confusing to many traders, because it is difficult to evaluate daily trading ranges. Many times, a trader will think that he or she was filled on a position or stopped out of a trade on a day order, when in fact the trade actually occurred at night when the order was not working.

[5]Others will enable you to choose between day session only, night session only, or day session *and* night session included in a single price bar.

Gold is often listed in the newspaper to include the overnight electronic market trading. Therefore, the open, high, low, and close quoted in print can be different than the trading at the Chicago Mercantile Exchange.

Example: Gold Monday Trading.

The client places an open order on Friday to buy one contract of December gold at 311.00.

The broker enters the order on the floor. The order is still working and is not filled that day.

The night session begins Sunday and counts as Monday.

Gold opens at 312.00.

Gold trades lower in Asia, so the electronic U. S. market trades lower as well.

Gold makes an overnight low of 308.00.

Some bullish news hits the London market later Sunday night, and gold prices rise.

Gold makes a night session high of 317.00.

Gold opens at 8:20 A.M. Eastern time on Monday.

The open outcry session open is 315.00.

Gold gets as high as 318.00 and as low as 314.50 and closes at 317.50.

On Tuesday, the client reads the paper and sees that gold had a low of 308.

The client immediately calls the broker looking for a fill.

PAPER	ACTUAL DAY SESSION
Open: 312.00	Open: 315.00
High: 318.00	High: 318.00
Low: 308.00	Low: 314.50
Close: 317.50	Close: 317.50

The client was not filled in this scenario, because the order was not working on the market where the gold traded at 308. The order was placed as an open order to work on the day session. If the client wanted a night session order, he or she should have specified this desire. The newspaper will typically show the first trade of that contract as the open. In this scenario, the first trade for Monday was Sunday night. The paper will also use the highest high as the high and the highest low as the low, regardless of the session during which it occurred. The close will always be the last trade of Monday's session.

Some computer systems also separate night trading from day trading (they all vary). Some will have the capability to segregate day sessions from night sessions, and others will not. Some will enable you to monitor the night session exclusively or combine it with the day session, and others will not. *Always triple check your data source before making any conclusions.*

Remember these rules:

1. All orders are assumed to be orders for day session pit trading unless otherwise specified.
2. In our example, the client would have needed to place a separate order for the Access overnight electronic market.
3. Electronic markets (to date) do not take open orders.
4. If an order is filled on overnight market, it does not cancel the day session. They are separate orders and must be handled separately.
5. If an order is filled on a night session, it is important to cancel or modify any relating orders that are still working.
6. Not all night-session contracts offset day-session contracts. (Kansas City, MO wheat is not offset by a night session fill of CBOT wheat.)
7. Electronic markets (to date) do not take stop orders.
8. Often, there are several night sessions that apply to one contract. Traders must specify a) whether the order is for all night sessions, and 2) on which electronic market the order is to be placed (EFP versus GLOBEX, for example).

Quiz

1. If you bought one contract of corn at $2.50 per bushel and it rose in price to $2.57, how much money would be credited to your account balance at the close of the day?
2. Determine whether this order is correct: "Please sell one contract of the June lean hogs at 49.99."
3. Determine whether this order would be correct: "Buy two March silver at 5.023."
4. Determine whether the following order is correct: "Buy two November soybean futures at 5.33 and 1/8."
5. If you bought one Mini-S&P 500 at 1,300.50 and it closed that day at 1,294.00, how much money would be debited from your account balance?
6. Futures traders have three days to meet margin calls. (true or false)
7. A broker should give "better clients" more time to meet a margin call, especially if he or she knows that the client has more money. (true or false)
8. Because cattle is quoted in cents and cocoa is quoted in dollars, you can assume that cocoa is more risky than cattle to trade. (true or false)
9. If the initial margin requirement for one coffee futures contract was $2,000 and the maintenance level was $1,500, how far would prices have to move against you in order to trigger a margin call? (Assume that your account only had $2,000 on deposit.)
10. If the initial margin for one contract of crude oil was $1,000 and the maintenance level was $800, how far would prices need to move against the position in order to trigger a margin call? (Assume only $1,000 on deposit.)

Answers

1. Corn gains $50 per penny move in your favor. If you were long corn and it gained 7 cents, your account would be credited with $350 at the end of the day.
2. No. Lean hogs trade in .025 increments. Usually, the last digit is assumed to exist. The floor broker would not accept an order to sell a contract at 49.99, because it could not trade at that price. An order to sell could be placed at 49.97 or 50.00.
3. No. Silver trades in .005 increments. Although silver can settle at 5.023, orders are generally only accepted with the .xx5 or .xx0. For example, an order would be accepted at 5.23 or 5.23-and-a-half (5.235).
4. No. Soybean futures trade in quarter-cent increments. (The options trade in eighths.) This situation can be confusing, because the computer screen often quotes prices as 5332—which translates literally to 5.33 2/8, or 5.33 1/4.
5. Mini-S&P futures have a contract size of $50 times the index. If you lost 6.50 points on the trade, your account would be debited $325 (1,300.50 − 1,294.00 = 6.50 × $50 = $325).
6. False. Margin calls must be met by deposit or liquidation by the close of trading that day.
7. False. Although it is tempting to give a good client more time to meet a call, sometimes the results can be disastrous. Although relationships are important (that is how you build a strong business), sometimes losses can become so excessive that even a friendship is not enough to pay them back. Both broker and client need to respect the limits.
8. False. Contract value is determined by multiplying the price times the contract size. Although cattle is quoted in cents per pound, the contract size is worth 40,000 pounds. Cocoa is quoted in dollars per ton, but the contract size is only 10 tons. If cattle were trading at 44 cents, the contract value would be $17,600. If cocoa is trading at $1,100, the contract value is $11,000. Also, never determine how risky a contract is simply by its price or value. The risk of a contract should be determined more by the liquidity.
9. Coffee has a contract size of 37,500 pounds. Each .05-cent move (tick) is worth $18.75. The account would have $500 or more to go on margin call. $500 divided by $18.75 equals 26.67 ticks, or roughly 27 ticks. 27 × .05 = 1.35 cents per pound. If you bought coffee at 99.00 and it fell in price to 97.65, you would be at risk of margin call.
10. This one is easier to calculate than coffee. Crude oil is priced in dollars per barrel. The contract size is 1,000 barrels. The minimum price fluctuation is one cent ($.01). The dollar value per tick is therefore $.10 × $1,000, or $10. The trade would have to lose $200 or more to go on margin call. $200 divided by $10 equals 20 ticks. 20 ticks × $.01 equals $.20 per barrel. Crude prices would have to move at least 20 cents per barrel in order to trigger a margin call.

NOTE

Numbers nine and ten are extremely important. Every broker and trader should be able to quickly calculate at what price level an account is likely to go on margin call. That way, the account can be more closely monitored by watching prices or by placing a protective sell stop should prices reach the level that might trigger a margin call.

Chapter 4

Studying: How to Interpret Prices and Understand Financial News

Introduction
Supply Side
Demand Side
Major USDA Agricultural Reports
Financial Reports
Financial Publications

Introduction

All commodity markets move with the shift in balance between supply and demand. Many factors influence the perception of how much supply and demand are likely. Weather conditions impact crop prices as the growing cycle progresses. Extreme weather disasters, such as hurricanes and tornadoes, destroy homes and can affect the demand and price for the lumber required to rebuild. Hurricanes have been known to devastate entire crops of oranges. Political decisions such as embargoes, trade tariffs, and supply quotas affect the supply and demand of commodity items. A country might have restrictions on how much it can export to the United States. Various countries can establish expensive tariffs that will reduce the flow of imports. Military uprisings, such as the Persian Gulf War, can also have an impact on commodity items such as crude oil.

Extreme conditions are rare, but there are consistent reports on the supply and demand for commodities. An obvious example is the grain markets. You might recall the giant moves that soybeans and corn have made during drought conditions. In fact, one of the biggest bull moves in the grain markets was the bull market of 1995–1996. Although many markets moved, let's take the example of corn (see Figure 4-1).

Each year, based on forecasted supply and demand, the *United States Department of Agriculture* (USDA) allocates the number of acres that should be planted with grain in the coming season. In this particular season, the existing supplies were ample, and foreign demand was slow. Consequently, the USDA cut the required acreage numbers to avoid a glut of supply at harvest time, which would pressure prices.

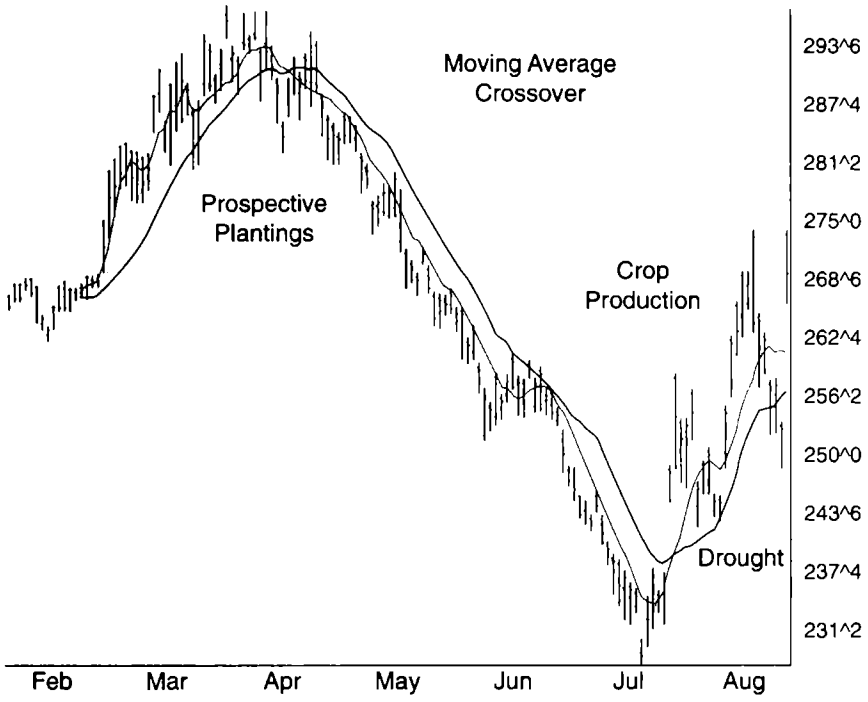
This announcement comes out on the last trading day of March every year. The initial reaction is for corn prices to rise in anticipation of smaller supply come harvest. Keep in mind, however, that the USDA has announced the planting intentions, but with many tumultuous weather extremes that can occur throughout the growing season, the market was already starting to become edgy. Also, unfortunately for the farmers, there were troubles with this season.

When it came time to plant corn, the Midwest was experiencing extremely wet weather conditions. The rain was so heavy and so frequent that there were rarely opportunities to plant the seeds. Tractors could not drive on the fields because the mud was so thick that the tires would sink.

Week after week went by, and the farmers were still not able to plant the required acreage. The timing for planting is important because of the cycle of corn maturation. The longer the farmers waited to plant, the more vulnerable corn would be to the hot, dry summer conditions. Ultimately, many acres of corn went unplanted.

As you can imagine, the price of corn began to skyrocket during this period. Although there was plenty of corn in the bins, and plenty was available for use at the current time, the perception that corn supplies would be dramatically limited in the future caused corn prices to rise pre-

Figure 4-1 *Corn chart, courtesy of TradeStation by Omega Research*



cipitously. In fact, corn eventually surpassed $4 per bushel, which is a lifetime record.

This move was exacerbated when weather conditions did not cooperate throughout the season. Crop progress reports released each week showed that corn was behind schedule in terms of maturation; consequently, yields would be down in the fall (see Figure 4-1).

The bullish consensus prevailed throughout the winter until it came time for the government to report its planting intentions for the following crop year. This time, to avoid any shortages, the USDA announced that it would designate more acres to plant corn than ever before. The USDA would ensure that there was an ample supply of corn for the next season. This news caused corn prices to fall in anticipation of more supply in the future. As you can see by the chart, December 1997 corn futures—which reflected the new crop for 1997—fell in price. As the growing season was underway and crop progress reports were released, there was some concern about a drought—and the prices spiked higher. Ultimately, however, the ample supply of corn prevailed—and corn prices stayed relatively low for the next several seasons.

Clearly, agricultural reports have a tremendous influence on futures prices. Knowing when the reports are to be released and the potential impact on the market is important.

NOTE

You should know that many times, a market will price in an upcoming report—particularly if it is expected to be extraordinarily bullish or bearish. Sometimes, a market will price in negative data before it is released—and unless it is much more negative than expected, the market might actually rally after the fact. This situation is what is called "sell the rumor—buy the fact." The same situation exists with bullish information. If a market report is expected to be bullish, unless it is extraordinarily bullish, the market might fall. This situation is called "buy the rumor—sell the fact."

Supply Side

Carryover inventories are the remaining inventories of the prior crop. If a substantial amount of the prior crop remains in storage, supplies might be considered excessive—and prices will be held down. On the contrary, if inventories are deemed low, prices of the current futures prices are likely to be high. Often, if a large crop is planted for the next season, prices of grains will be dramatically lower in the new crop season (November for beans and December for wheat and corn).

Planting intentions are estimates of how much will be planted in each crop year. These reports are released at the end of the first quarter. This report is the market's first official look at the new crop year.

Weather/crop progress reports (crop projections) are released throughout the growing season. Weather reports also factor largely in the market's assessment of the final crop yield.

Final harvest results (final supply figures) are determined, and sales versus new inventories are tallied.

Demand Side

Livestock reports—Because cattle, hogs, and chickens are the largest consumers of corn and soybean meal, agricultural traders also monitor regular livestock reports.

Foreign purchases—Traders watch other major countries (such as China and the former Soviet Union) to assess their potential import demand. Population growth rates, domestic production, and economic strength are monitored in order to determine a country's need and ability to buy agricultural products.

NOTE

A large part of what led to the depression of commodity prices in the late 1990s was the weakness in foreign countries. Asia in particular was experiencing negative growth, and its economies were actually contracting. Asia's currencies were also weakening, and this factor reduced its purchasing power. With little growth and lack of purchasing power, demand for commodities and other goods was low. Without a strong overseas export market, demand was sluggish—and grain and other commodity prices were depressed.

Major USDA Agricultural Reports

The following list describes the major agricultural reports, what they contain, and the approximate time they are released. Always double check the calendar for scheduled events. Either the exchanges or major brokerage firms should provide a calendar of reports. The following dates and listings are subject to change without notice:

Report	Schedule
All Hogs and Pigs	Quarterly
Cattle on Feed	Monthly
Cold Storage	Monthly
Crop Production	Monthly
Crop Progress	Weekly, April–December
Export Inspections	Weekly
Export Sales	Weekly, April–December
Grain Stocks	Quarterly
Prospective Plantings	End of March

All Hogs and Pigs

This information, reported quarterly, provides a snapshot of the current supply of hogs and pigs in the marketplace. This figure tells the market what volume of supply of pork product is available at the time.

Cattle on Feed

This information is broken down into All 7 States, Marketing, and Placements. Cattle on Feed reflects the flow of supply of cattle at various stages in the raising and slaughtering cycle. Placements, for example,

refers to the number of cattle that are placed in feedlots after grazing in the pasture for their first year, where they are fattened up for four to eight months before being sold to slaughter.

This information provides an idea of what the future supply of cattle will be in the coming months.

Cold Storage

Bellies—Bellies are released each month and as a percentage change month to month. This information determines whether the storage is greater than the month prior or less.

Pork on Hand—Released weekly on Friday as a percentage of the prior week

Frozen Orange Juice:—Released monthly; reflects the amount of frozen concentrated orange juice stored in warehouses

Crop Production

Crop production reports are released each month throughout the primary growing season. This information provides an update as to how the crop size and quality are progressing. All data reported for the end of the month are actual numbers for the first day of the following month. This report includes data for grains, cotton, orange juice, sugar, and other agricultural products.

Crop Progress

This information includes plantings, crop conditions, and the progress of harvest, in addition to giving the market a weekly update as to how the cycle is progressing as compared to the average. If corn is behind schedule in planting, for example, the crop might be more vulnerable to the hot, dry conditions of summer. The crop condition is ranked as poor, good, very good, and excellent. Each week, sample sets of acreage are evaluated as to their overall condition.

The progress of harvest is important as well. For example, the longer that soybeans remain in the ground, the more vulnerable they might be to an early frost.

Export Inspections

This report is released weekly on Thursday and reflects the amount of grain that has been inspected for export. This information gives an idea of the overseas demand.

Export Sales

This report is released weekly on Thursday and reflects actual sales of the product for export.

Grain Stocks

Grain stocks are released by the USDA quarterly. This report provides an update of the supply of grains (wheat, corn, and soybeans) in the United States and gives the marketplace an idea of how much of a product is on hand at the end of each quarter.

Prospective Plantings

This report is released at the end of March and provides the market's first look at the anticipated size of the coming crop. This information can set the tone of trading throughout the growing season.

As mentioned previously, market reports are subject to many changes without notice. Always double check the calendar of events and what is included in the report. Because market reports can dramatically influence the tone of the market, you *must* educate yourself on their nuances.

Financial Reports

Consumer Price Index (CPI)

The CPI reflects the inflation rate at the consumer level and is established by the Bureau of Labor Statistics. You calculate the CPI by establishing the price of a fixed basket of goods and services that are selected based on their direct impact on average citizens (for example, food, gasoline, housing, energy, and medical care). If these costs are rising at the consumer level, it might indicate a rise in the inflation rate. The CPI is also called the cost-of-living index.

In the headline release, numbers are indicated as a percentage increase over the previous month. There is also a release called the core rate, which is the monthly increase in prices excluding volatile food and energy prices. The core rate is most closely followed as an inflation gauge.

Producer Price Index (PPI)

The PPI is the market index that measures price changes at the wholesale level. PPI is also called an inflation index at the wholesale level. Included in the calculation are prices of goods at the crude (raw) level, intermediate level, and finished level (for example, inputs such as food, tobacco, and energy on the raw end). As well as computers, truck and car prices are at the finished end.

Like CPI, PPI is released as two headline numbers: the overall percentage increase in prices month to month, and the core rate (which excludes food and energy). The core rate is the most closely followed indication of inflation.

Gross Domestic Product (GDP)

The GDP is the value of all goods and services produced in the country. The GDP is the broadest measure of economic activity and the principal indicator of economic performance—the most comprehensive reading of the nation's economic health. If the economy is expanding, the GDP is positive. If the economy is retracting, the GDP figure is negative. A recession is defined as two consecutive quarters of negative GDP.

The GDP report has two other major components: the GDP implicit deflator and the GDP fixed-weight deflator. The implicit deflator is the ratio of current-dollar GDP to constant-dollar GDP, which reflects both the changes in prices of all goods and services that make up GDP and changes in the composite of GDP. The fixed-weighted deflator is the sum of the deflators for individual components of GDP, with each component weighted by its share of real GDP (and consequently, it provides a better gauge of inflation). Included in the GDP figure is a value called Personal Consumption, which reflects the spending habits of the nation's residents.

As the economy molds over time, different components of each indicator have more significance. This fact depends on what elements of the economic growth or retraction are affecting Federal Reserve policy the most.

Three official releases of GDP exist: a preliminary, a revised, and a final figure for each quarter.

Industrial Production (IP) and Capacity Utilization (Cap. U.)

IP measures output in manufacturing, mining, and utility industries. Activity in manufacturing accounts for 85 percent of this figure, while the remainder comes from output in the utilities and service sectors. This value is a measure of actual volume of output in goods-producing industries, uninfluenced by prices—one of the more important economic indicators.

Capacity utilization is the percentage of production capacity in use by a particular company, industry, or the entire economy. In theory, a company can operate at 100 percent, but in reality, machine repair, vacation leave, and so on prevent that occurrence.

National Association of Purchasing Managers Index (NAPM)

The NAPM is a composite index of new orders, production, supplier deliveries, inventories, and employment and is a reflection of strength in the manufacturing sector. If the sector is greater than 50, the industry is said to be expanding; if it is under 50, the industry is said to be weakening. Two components of interest are the Price Paid and Prices Received indices. They reflect whether or not prices are rising in the manufacturing sector, which can hint that inflation might be on the rise.

Chicago Purchasing Managers Index (Chicago PMI)

The Chicago PMI, a survey of manufacturing activity in the Chicagoland area, is an early indication for NAPM. The Chicago PMI also includes prices paid and prices received that are an indication of price pressure (which, if rising, can signify inflation). If the price pressure is falling, this situation can indicate an economic slowdown.

Durable Goods

Durable goods is a manufacturing output report that focuses on new orders. This value is an extremely volatile number that reflects factory orders for shipment.

Employment

Employment refers to a survey of households that provides timely information concerning the rate of employment. If the economy is doing well, the unemployment rate is usually low as a larger percentage of the population is employed. Unemployment often proves to be a major market mover, particularly if the result is significantly different than the expectations. (People affectionately refer to this term on the trading floors as *unenjoyment.*)

Housing Starts

The housing starts value measures the start of construction of a house or apartment building, which means digging the foundation. These starts are closely monitored for turning points in the business cycle and are released by the Commerce Department monthly.

Retail Sales

Retail sales are a measure of consumer spending, reporting on sales of both non-durable and durable consumer goods.

Employment Cost Index (ECI)

ECI is a comprehensive measure of wage and related cost inflation. The ECI includes not only compensation costs, but also benefit costs paid by the employer (including Social Security contributions). This figure is a quarterly report and is an indication of the rise and fall of labor costs. The ECI can signal when inflation might be creeping into the economy.

Philadelphia Fed Survey (Philly Fed)

The Philly Fed is an index of business conditions in the manufacturing sector—the first reading of its kind released each month. Two components of interest are the Prices Paid and Prices Received indices that gauge whether inflation pressures are building. The survey is conducted by polling manufacturers to get an idea of the confidence level in their sector. This survey can give an early view of the larger and more significant NAPM index, although it is not as correlated as the Chicago PMI.

Atlanta Fed Survey (Atlanta Fed)

The Atlanta Fed survey reflects how manufacturers who conduct business in the Atlanta Federal district think about business conditions in their industry overall. This survey includes Prices Paid and Prices Received.

Productivity

Productivity refers to the level of output per unit of input (for example, the quantity of product produced per hour of labor). Productivity in a firm is often rewarded with reduced labor costs and consequently greater profitability. Productivity data is analyzed on a quarterly basis, and there are several releases of this figure as it is revised occasionally.

Consumer Credit

Consumer credit refers to the level of debt at the consumer level (released monthly).

University of Michigan Consumer Sentiment

This sentiment is a measure of confidence at the consumer level and indicates the general consumer view regarding economic prospects, price inflation, the employment picture, and the interest-rate environment. Results are a good indication of the larger Consumer Confidence survey results.

Leading Economic Indicators Index

The Conference Board releases this index, which helps to reaffirm other statistics.

Construction Spending

Construction spending is simply the amount of money spent on construction. If this figure is strong, it can give an indication that other figures, such as the GDP, will be strong as well. This information is released monthly.

New Home Sales

New home sales are a reflection of the strength in the housing market. This value reflects not only the quantity sold, but also the average price. New home sales are an important indication of strength in the economy.

Existing Home Sales

This value refers to the number of homes that are currently housed and then sold to a new owner. The average price paid for a home is also in this number.

National Association of Home Builders (NAHB) Survey

The NAHB survey provides an early indication of the industry's view regarding current and future sales, as well as the number of interested buyers. A number of more than 50 is generally a positive indication, and a number below 50 indicates expectations of a slowdown in the housing market.

Automobile/Light Truck Sales (Auto Sales)

Auto sales are a unit account for all vehicles sold in a one-month period. The higher the number, the more the number represents strength and confidence in the economy. A weaker number represents a potential slowdown.

Personal Income

Personal income refers to income received by individuals, nonprofit organizations that serve individuals, private non-insured welfare funds, and private trust funds. This income includes items such as wages and salary disbursements, labor income, dividends, and interest income.

Personal Consumption

Personal consumption reflects the level of individual expenditures on goods and services.

Business Inventories

The level of inventory increases or decreases at the wholesale or retail level. Business inventories reflect the stock on hand, new shipments, and the inventory-to-sales ratio. If inventories are low, it implies that sales are going strong. A buildup in inventory levels can indicate a slowdown in sales growth.

Factory Orders

Factory orders are a monthly report of new orders at the factory level.

Retail Sales

Retail sales involve a report that measures the strength of sales at the retail level. This information can give insight into the Personal Consumption figures of the GDP. Retail sales reflect consumer demand in the economy and are released monthly.

Trade Balance

The trade balance means the level of exports minus imports. If we import more in value of goods and services than we export, we operate at a trade deficit.

This figure is released monthly. If our economy is doing well, we tend to consume more and perhaps import more. As other economies strengthen, they tend to consume more and likely import more goods and services—thus, our exports increase. Currently, the United States operates at a giant trade deficit.

Beige Book

The beige book is a Federal Reserve survey of economic conditions and a summary of 12 Federal Reserve regional district banks. The report is compiled eight times per year.

FOMC Meeting

The Federal Reserve meets nine times per year to discuss the outlook for interest rates. The Federal Reserve has the power to change the federal funds rate as deemed appropriate, in order to stimulate growth or to prevent inflation. Interest-rate changes and economic outlooks usually are announced at the close of this meeting.

Humphrey-Hawkins Testimony

This testimony is a report produced and presented by the chairman of the Federal Reserve twice per year. The testimony is usually given to the House and Senate in February and July. The statement discusses the outlook for the economy, the conduct of monetary policy, and the expectations for inflation and other economic conditions in the coming year. The chairman might also discuss target ranges for money supply growth and nonfinancial debt.

Money Supply

Money supply refers to the total amount of money in the economy (as measured by bank deposits) that can be withdrawn on command and currency help outside of commercial.

Financial Publications

Barron's, 22 Cortlant St., New York, NY 10007
Commodity Yearbook, Knight-Ridder, Trade Center 25 Hudson, New York, NY 10006
Wall Street Journal, 22 Cortlant St., New York, NY 10007
Financial Times (800) 628-8088 or www.ft.com
Bloomberg Magazine, 499 Park Ave., New York, NY 10022 (212) 318-2000
Futures Magazine (312) 977-0999
Investor's Business Daily (www.investors.com)

Web Sites:

Wall Street Journal Interactive: www.wsj.com
www.FuturesView.com—Provides excellent insight into futures trading; great for beginners or experts. It also provides market research, calendars, contract specifications, and trading tips.
www.TheStreet.com—Provides unique insights into the global marketplace
www.Bloomberg.com—Provides up-to-the-minute information about stock, the economy, and interest-rates
www.WSJ.com—The *Wall Street Journal* online
www.FT.com—Another great source for economic news
www.cftc.gov—Web site for the *Commodity Futures Trading* Commission (CFTC)
www.nfa.org—Web site for the *National Futures Association* (NFA)

Chapter 5

Buying and Selling Futures

Introduction

Order entry is one of the most important techniques to learn with respect to futures trading. Regardless of your success with technical analysis or risk management, you can whisk away all potential profits with one error in order entry. One simple mistake is saying "buy" when you mean "sell," or saying "October" when you mean "November." Or, the sneakiest error of all—forgetting to cancel an open order after you have liquidated a position. This action can cost you thousands of trading-profit dollars. More often than not, these errors will be your own, and there will be no other party to blame but yourself. Thus, you must accept the financial consequences. Do not take this chapter lightly; make it a point to master the skills of proper order entry. Learn to follow simple procedures each time you enter an order.

Rules for Futures Order Entry:

- Identify yourself. Know and use your account number, because it is your primary means of identification. Your number is used for order entry, margining, and accounting. Begin every order by stating your account number.
- State your intent (whether you want to buy or sell). You might also want to indicate whether the trade is to initiate or offset. Remember, a buy is only offset with a sell, and a sell is only offset with a buy.
- Be clear about quantity. If you are long five contracts and you wish to sell them, state clearly that you wish to sell five. If you place a limit order, you might possibly not get all of your contracts filled. When entering a market order, you might be filled at different prices for each of your contracts.
- State the month and the year. Always remember that each delivery month is an entirely different contract, and they do not offset each other. Be specific as to the month in which you wish to trade. If you trade a contract that is more than a year from now, be sure to clarify this point. A March 2001 Euro dollar is not the same as a March 2002 Euro dollar. If the month is January and you place the order as a March contract, the exchange assumes the month to be March of the current year. If the month is June and you place an order for a March contract, the exchange assumes that the order is for March of the following year. If the month is January and the order is intended for March of the following year, you must clearly state this point. The exchange always assumes that orders are meant for the month that is closest to the entry date.

- Specify the contract. There are similar contracts that trade on different exchanges, so be sure to clarify. For example, a CBOT wheat contract is not the same as a Kansas City Board of Trade contract. They do not offset each other.
- The order type involves the price at which you desire execution. Many specific details differentiate order types.

These are all critical steps toward getting the order entered correctly. We will go through several examples together later in this chapter. Next, let's discuss the types of futures orders that you can enter.

Types of Orders

Many types of orders are designed for various types of execution. Some are designed for speed, and some are designed to specify price. Still others are designed to limit losses. Each order has certain characteristics and is valid at different times.

Market Order

Market orders demand immediate execution. When entering a market order, you state the number of contracts that you wish to buy or sell in a given contract month. You do not specify price, because your objective is to have the order executed as soon as possible at the best possible price:

BUY	SELL
	1 June S&P MARKET

"Sell one June S&P at the market"

In this situation, the broker is instructed to sell one June S&P futures contract at the next available price.

Limit Order

Limit orders specify a price limit at which the order can be executed. You must be filled at your stated price or at a price that is better. The good news is that you know the worst price at which you can be filled. The bad news is that you might not get filled, because the market did not trade through your price. A limit order to buy is set at a price below the last market price. A limit order to sell is placed at a price that is above the latest market price. In most cases, when a price is specified, it is considered a limit order:

BUY	SELL
1 December corn 2.35	

"Buy one December corn at two thirty-five," or "Buy one December corn contract at two thirty-five limit."

In this situation, the broker is instructed to buy one December corn contract at 2.35 or lower:

2.38 Market Price
2.37
2.36
2.35 Limit Price
2.34

Market if Touched (MIT)

An MIT order can only be filled if the market reaches a particular price. An MIT order becomes a market order as soon as the market trades at the stated price. As with a limit order, an MIT order to buy is placed below the latest market price, and an MIT order to sell is placed above the market price. The difference is that because an MIT order becomes a market order, it is filled at the next available price—which might be different (better or worse) than the original stated price:

BUY	SELL
	5 December Gold 301 MIT

"Sell five December gold at three-oh-one market if touched," or "Sell five December gold at three-oh-one MIT."

In this situation, the broker is instructed to sell five December gold contracts if the market touches 301 in price. Once the market trades at 301 or higher, the order in effect becomes a market order and is filled at the next available price:

301 Sell MIT Order Price
300.90
300.80
300.70
297.10
297 Market Price
296.90

Stop Order

A stop order specifies a price that, when reached, converts the stop order into a market order. You place a stop order when you want the market to trade at a certain level before the trade is executed. A stop order to buy is placed above the latest market price (called a buy stop). A stop order to sell is placed below the latest market price (called a sell stop). If the market opens above a buy stop, the order is filled at the first available price. If the market opens below a sell stop, the order is filled at the first available price:

BUY	SELL
1 June Swiss franc 6200 STOP	

"Buy one June Swiss franc at sixty-two-hundred on a stop," or "Buy one June Swiss franc at sixty-two even stop."

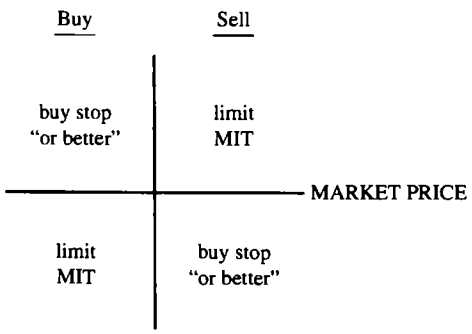
In this situation, the broker is instructed to buy one June Swiss franc if the market trades at 6200 or higher. Once the market trades at 6200 or higher, the order in effect becomes a market order and is filled at the next available price:

6200 Buy Stop Order Price
6199
6198
6197
6196 Market Price

Help for Remembering

For assistance in remembering which order is appropriate when the order is not a market order, consider the following diagram (Figure 5-1):

Figure 5-1 *Order grid*



The horizontal line represents the last market price—either the close (if the order is entered before the open) or the most current price of the futures contract upon entering the order. An order to buy is indicated on the left-hand side, and an order to sell is indicated on the right-hand side.

If the price stated on a buy order is above the market price, then the order *must* be designated as a stop or as an "or better" order (again, unless the order is a market order). The trader must determine whether he or she wishes to buy the contract at the current price or better (lower) or only if the market trades at the stated price or higher (stop order). If the order is not designated as one or the other, it will be either kicked out of the pit or filled incorrectly. Both actions can be expensive.

If the price stated on a sell order is above the market price, the order *must* be either a limit order or designated as an MIT order (unless it is a market order). The trader must decide whether he or she would like a limit order (which will not be filled unless it can be filled at the stated price or higher) or an MIT order (where the order will become a market order if the market trades at the stated price or higher). An MIT order must be specified on the ticket. A sell order with a stated price above the current market price is assumed to be a limit order unless otherwise specified.

If the price stated on a sell order is below the market price, then the order *must* be designated as a stop or as an "or better" order (again, unless the order is a market order). The trader must determine whether he or she wishes to sell the contract at the current price or better (higher) or only if the market trades at the stated price or lower (stop order). If the order is not designated as one or the other, it will be either kicked out of the pit or filled incorrectly. Both can be expensive disruptions.

If the price stated on a buy order is below the market price, the order *must* be either a limit order or designated as an MIT order (unless it is a market order). The trader must decide whether he or she would like a limit order (which will not be filled unless it can be filled at the stated price or lower) or an MIT order (where the order will become a market order if the market trades at the stated price or lower). An MIT order must be specified on the ticket. A buy order with a stated price below the current market price is assumed to be a limit order unless otherwise specified.

A tip for remembering these details is to memorize the phrase, "Buy stop above the market." Once you have that phrase memorized, then you can deduce that a sell stop must be below the market, and everything else falls into place.

Stop Close Only (SCO) Order

This order is only executed if the market trades at the stated price (or worse) during the closing range. The order is not executed, regardless of price, at any other time during the trading day. A sell SCO order is only executed if the market is trading at the stated price or lower during the close. A buy SCO order is only executed if the market is trading at the stated price or higher during the closing range:

BUY	SELL
	2 September Dow Jones 10110 SCO

"Sell two September Dow Jones contracts at ten-thousand one-hundred and ten stop close only," or "Sell two September Dow Jones at one-oh-one-ten Stop Close Only."

This order will only be filled if the closing range of the September contract is at 10,110 or lower:

Closing Range 10120—10100 Filled
Closing Range 10150—10130 Not Filled
Closing Range 10080—10060 Filled

Again, this order will not be filled unless the market has a closing range of 10110 or lower, regardless of the price action during the day.

Stop Limit Order

This order puts a limit on the price that you will accept once a stop order is executed. Most stop orders become market orders, but a stop limit order becomes a limit order. The advantage is that you know the worse price at which your order can be filled. The disadvantage is that you might not have your order filled at all. A stop limit order has two prices associated with it. The first is the stop order, which is the trigger price of the order; and the other is the limit price, which is the defining price. Both prices are written on the same ticket. The stop portion of a buy stop limit order is placed above the latest market price. The limit portion of a buy stop limit order is placed above the stop price. The stop portion of a sell stop limit order is placed below the latest market price. The limit portion of a sell stop limit order is placed below the stop price:

BUY	SELL
1 March Euro dollar 9400 STOP 9405 LIMIT	

"Buy one March Euro dollar at ninety-four-hundred stop, ninety-four-oh-five limit."

This order instructs the broker to buy one March Euro dollar contract if the market trades at 9400 or higher but not to pay more than 9405. Essentially, this stop order becomes a limit order once the market trades at the stop price:

9408
9407
9406
9405 Not filled higher than here
9404
9403
9402
9401
9400 Stop Executed
9399
9390 Market Price

Order Cancels Order (OCO)

OCO simply means that one order cancels the other. If you wish to place a target and a stop on a trade, you can elect to perform this action on an OCO basis. Both prices are written on the same ticket. The sell limit portion of a sell OCO order is placed above the latest market price. The sell stop portion of a sell OCO order is placed below the latest market price. The buy limit portion of a buy OCO order is placed below the latest market price. The buy stop portion of a buy OCO order is placed above the market price. Once one side of the trade has been executed, the broker then cancels the remaining side. Floor brokers rarely accept OCO orders, particularly if they are of small size. OCO orders are too risky in most conditions to monitor. Full-service brokers still accept most OCO orders, which are sometimes referred to as contingency orders:

BUY	SELL
	1 March S&P 1401.00 STOP OCO 1410.00 LIMIT

"Sell one March S&P at fourteen-oh-one even stop, oh-see-oh, fourteen-ten even limit."

This order instructs the broker to sell one S&P at 1401.00 or 1410.00, whichever comes first. The stop at 1401.00 stop side will be filled if the market trades at that price or lower. The 1410.00 limit side will only be filled if the broker can get 1410.00 or higher:

1421
1410 Sell limit executed; sell stop canceled
1409
1408
1407
1406
1405 Market Price

1404
1403
1402
1401 Sell stop executed; sell limit canceled
1400

Contingency Order

Most professional brokers will accept contingency orders. A contingency order is any order that requires special attention and is sometimes referred to as an "if-then" order. For example, if you are long a T-bond contract and you have both a target and a stop working, you can instruct your broker to cancel one order if the other is filled. This capability offers the great advantage of freedom. Although OCO orders serve this function, they are not accepted at all exchanges. You do not have to wait and watch the prices all day for fear that you will risk a double-fill; rather, you can let your broker watch them for you.

Another example of a contingency order might not involve a transaction. Perhaps you just want a phone call if the market trades at a certain price (for example, "*If* the market trades at 100, *then* call me at the office"). A broker can do that for you.

If you have a price target in mind on the futures contract but you own an option, you can tell your broker "*If* the market trades as high as 1500, *then* sell my call option." Contingency orders can offer freedom to the investor by eliminating the need to watch the market all day.

Trailing Stop

Another form of contingency order is the trailing stop order. A stop order is designed to limit losses or lock in profits in the event of a market turnaround. If you are a short-term trader, it might important to alter your stop as the day progresses. A broker can also handle this task for you. Say, for example, that you would like to raise your stop every time the market advances five points in your favor. You might not have the time or the desire to watch the market that closely. A broker has the time and the equipment to monitor your trade for you. Many systems require a trailing stop and an exit on the close. You can instruct a professional broker to monitor your trade, move the stop if necessary, and exit the trade on the close. Obviously, there is a higher fee for this type of service, but it might be worthwhile. Again, all fees are negotiable.

Not Held

In many situations, particularly in volatile ones, exchanges can announce that all orders entered into the pits are not held. This rule is designed to protect the floor brokers from fault if market conditions are exceptionally wild. The rule states that all limit, stop, and even market orders cannot be held to a certain price. For example, market conditions might be too volatile for brokers to guarantee good fills on market or stop orders.

Conditions might be such that limit orders might be difficult to fill at the desired level, even if the market trades through the price. The exchange declares not held conditions if warranted.

Not held can also refer to an individual broker, as in the trailing stop example given earlier. A broker is willing to take on the responsibility of monitoring your trade for you but might claim that he or she is not financially responsible for slow or bad fills. This situation might occur if your request is difficult to monitor. For example, if you request that your stop be moved every five ticks in the bond market, this procedure cannot be physically called to the floor and accomplished every few minutes. The broker will likely place a trailing alert signal and sell your contract if the market trades at the appropriate price. The broker will always do the best that he or she can, but in some instances, the risks are too great to be responsible for every tick in the market.

Good Until Canceled (GTC) Order

A GTC is also called an open order. Most orders can be placed on a GTC basis. This type of order is valid until it is either filled, canceled, or the contract expires. Do not forget to cancel open orders if they are no longer needed, however. Liquidation of a position does not cancel open orders, so you must cancel them separately. Do not forget, or else it will cost you money. Always state up front whether your order is an open order or a GTC order. When you finish entering the order, state it again.

Spread Order

A spread order involves buying one type of contract and selling another (for example, buying one contract of November 2001 soybeans and selling one contract of November 2002 soybeans). A spread order can also involve different products; for example, buying one contract of December heating oil and selling one contract of December unleaded gasoline. The buyer of a spread hopes to profit from the widening of the difference in prices, and the seller of a spread hopes to profit from the narrowing of the difference between prices. For example, if you buy November 2001 soybeans and sell November 2002 soybeans, you hope that the price of the November 2001 contract rises faster than the 2002 contract does. Or, perhaps the price of the November 2001 contract will fall less than the price of 2002. Either way, you hope that the November price continues to be more expensive, wider, or less negative than the November of the following year. The seller of that same spread hopes that the opposite will occur—that the price of 2002 will get closer to the price of November 2001. The same is true for the December heating oil versus December unleaded gasoline. The buyer hopes that the price of heating oil will rise faster than the price of the unleaded gasoline (or, at the very least, that it will fall more slowly than the price of unleaded gasoline). The spread of price between the two will widen. The seller of that same spread hopes that the price difference will narrow or become more negative.

Example. Buy one contract of November 2001 soybeans at $5.70 per bushel. Sell one contract November 2002 soybeans at $5.75 per bushel.

Day One:	Buy	Sell	Spread (buy – sell)
	5.70	5.75	–.05
Day 30:	**Sell**	**Buy**	**Spread**
	6.00	5.90	+.10

The trader made 30 cents on the November 2001 contract (6.00 – 5.70 = .30) and lost 15 cents on the sell of the 2002 contract (5.75 – 5.90 = –.15). The net profit was 15 cents, or 15 × $50 = $750.

Example. Buy one contract December heating oil at 63 cents per gallon. Sell one contract December unleaded gasoline at 76 cents per gallon.

Day One:	Buy	Sell	Spread (buy – sell)
	63.00	76.00	–13.00
Day 30:	**Sell**	**Buy**	**Spread**
	62.00	74.00	–12.00

The trader lost .01 cent per gallon on the buy (62.00 – 63.00 = 1.00). The trader made .02 cents per gallon on the sell (76.00 – 74.00 = 2.00). The net profit was 1.00, or $420 per contract ($.01 per gallon × 42,000 gallons).

When placing a spread order, you should always place the limit price on the side on which it is positive. For example, these two trades would look like the following:

Soybeans:

BUY	SELL
1 Nov. 2001 Soybeans	1 Nov. 2002 Soybeans +5

"Buy one contract of November 2001 soybeans and sell one contract of November 2002 soybeans at a credit of 5 cents to the sell side."

Offset soybeans:

BUY	SELL
1 Nov. 2002 Soybeans	1 Nov. 2001 Soybeans +10

"Buy one contract of November 2002 soybeans and sell one contract of 2001 soybeans for 10 cents to the sell side."

Energies:

BUY	SELL
1 Dec. heating oil	1 Dec. unleaded gas +13.00

"Buy one contract of December heating oil and sell one contract of December unleaded gasoline at 13 cents to the sell side."

Offsetting energies:

BUY	SELL
1 Dec. unleaded gas 72.00	1 Dec. heating oil

"Buy one contract of December unleaded gas and sell one contract of December heating oil for 12 cents to the buy side."

What Else Happens When You Place an Order? Two things happen when you place an order: 1) you get a confirmation of the order that you are about to enter, and 2) a confirmation number is assigned to the transaction.

1. When you place an order, the order should be repeated back to you. This procedure is either done verbally, whereby the phone clerk or broker repeats the order to you, or visually, whereby the computer gives you a chance to check what you have entered. Either way, always be certain to confirm that the order you entered was what you intended. Listen carefully to the order when it is repeated back to you, because this step is a critical part of error prevention. When the computer flashes a confirmation, read it carefully before you approve it.

2. Every time you place an order, you should be given a confirmation order number. Whether you enter the order online or over the phone, you

should receive a ticket number that serves as a confirmation of the transaction. The ticket number serves as your receipt or proof that you entered the order, and it also serves as a reference number if you need to check on the status of the order. Also, you will need the order number in hand if you wish to cancel an order that you have placed.

How to Cancel an Order. After you enter an order, always be certain to make a note of the ticket number that you were assigned. This number is what you will need to cancel or change the order in the future. Always keep accurate records. These accurate records could mean the difference of thousands of dollars in the event of an error. When you need to cancel an order, have the ticket number handy.

Phone Orders. A day ticket conversation would sound something like the following:

> "This is account 12345, I have a straight cancel. Please straight cancel ticket number 456, which was buying five contracts of November beans at 544."
>
> Clerk: "You wish to straight cancel ticket number 456, which was buying five contracts of November beans at 544. Is that correct?"
>
> Client: "Yes."
>
> Clerk: "OK, I am going to straight cancel ticket 456. Your out number is 735."
>
> Client: "OK, ticket number 735 straight cancels 456. Thank you."

Similarly, an open order would progress in the following manner:

> "This is account 12345. I have a straight cancel on an open order. Please straight cancel open order number 456, which was buying five contracts of November beans at 544. Straight cancel."
>
> Clerk: "You wish to straight cancel open order number 456, which was buying five contracts of November beans at 544. Is that correct?"
>
> Client: "Yes."
>
> Clerk: "OK, I am going to straight cancel open order number 456. Your out number is 735."
>
> Client: "OK, number 456 is cancelled. Thank you."

Computer Orders. Online order-entry programs differ in style. They should all have a section that saves the orders that are currently working. You should be able to select the order that you wish to cancel. The computer will also give you a chance to confirm that the order is correct and then give you a new confirmation number.

How to Change an Order. You might want to change orders throughout the day or as the week progresses. When you change an existing order, you are performing a cancel-replace. In a cancel-replace, you will need to give your account number, the previous ticket number, what the order was doing, and how you would like to change the ticket.

Phone Orders.

Day Order

"This is account number 12345. I have a cancel-replace. Please cancel ticket number 456, which was to sell one June hog at 4435 on a stop. The new order is to sell one June hog at 4505 stop."

Clerk: "I am going to cancel ticket number 456, which was selling one June hog at 4435 on a stop, and replace it with a new order to sell one June hog at 4405 on a stop. Is this correct?"

Client: "Yes."

Clerk: "OK, new ticket number 457 sells one."

Or, the conversation for a phone order could occur as follows:

"This is account 12345. I have a cancel-replace on ticket number 456. The old order was selling one June hog at 4435 on a stop."

Clerk: "OK, I have the ticket, what would you like to do?"

Client: "I would like to cancel the stop at 4435 and raise it to 4505."

Clerk: "OK, I am going to cancel ticket number 456, which was selling one June hog at 4435 stop. I am going to place a new order, which is to sell one contract of June hogs at 4405 on a stop. Is this correct?"

Client: "Yes."

Clerk: "OK, your new ticket number is 457, selling one June hog 4405 stop."

Client: "OK. New ticket is number 457."

Open Order

"Account 12345, I have a cancel replace on an open order. Please cancel ticket number 456, which was selling one June hog at 4435 stop. The new order is to sell one June hog at 4405 stop, good until canceled."

Clerk: "We are going to cancel and replace open order number 456, which was selling one June hog at 4435 on a stop. The new order will be to sell one June hog at 4405 stop, good until canceled. Is this correct?"

Client: "Yes."

Clerk: "OK, your new ticket will be 457, selling one June hog at 4405 stop, good until canceled."

Client: "OK, ticket number 457 sells one GTC."

Notice how certain aspects of the order are repeated several times. This procedure should never be taken lightly. The client states that it is an open order at the beginning of the conversation as well as at the end. The clerk repeats what the client says, sometimes more than once. The fact that it is a buy order or a sell order is stressed several times, and the ticket number is repeated as well. Phone lines are usually recorded. If these procedures are followed correctly, errors rarely happen—and if they do, detecting which side of the conversation is responsible for the error is easy.

In the next section, we will discuss examples of how most novice futures traders enter orders. This time, we will discuss how to enter option orders.

How to Enter an Options Order Correctly. Regardless of how long you have been trading or how well you have studied, throwing away trading profits is easy if you are not careful with your order entry.

Traders—even those who have many years of experience—still have the capability to make errors. Many clients get lazy with their order-entry skills when they are working with a professional broker. The most common error is saying sell when you mean buy.

This situation often occurs when trading option contracts. Let me share an experience of mine with a good client who had many years of trading experience. He was often short option contracts, and when it was time to liquidate his position, he would say something like, *Go ahead and sell my cattle options for me.* Thank goodness he was working with a full-service broker. If he had entered this order with a discount desk or online, the result could have been disastrous. Virtually everything was wrong with this order. For example:

Client Position:
Short
10
June
Live Cattle
75 strike
Call options

1. He was short cattle options already, and by selling them again, he would not liquidate his position; rather, he would double it. Instead of being short 10 cattle options, he would be short 20. Also, to make matters worse, if this error occurred, he would think that he was flat the market and consequently stop watching the market as closely. The financial implications of this situation could be exorbitant, particularly if these options went in the money and then he was assigned futures. Believe me, you do *not* want to make this mistake.

2. Assuming that we were clear that he meant to liquidate his position, he still did not indicate the quantity he desired. Did he want to liquidate his entire position, or just part of it? You must state the quantity clearly. He was short 10.

3. He then was not clear about the cattle contract to which he was referring. For example, this trader was often trading both live and feeder cattle. You must be clear about the exact contract you wish to trade. They were live cattle options.

4. To which contract month was he referring? If you bought August options but you were short June options, you would now be in a calendar spread—long one month (August) and short the other (June). Let's say that the month was June.

5. What is the strike price? There are many different strike prices on live cattle options, so which one did he wish to buy back? If you are short one strike price and then buy another, you are not flat; rather, you are now in an option spread. He was short the 75 strike price.

6. Were they calls or puts? This situation presents another big error. So often, calls are associated with buying and puts are associated with selling. So, many traders are short calls, and they call to place an order to buy puts. Puts and calls do not offset each other; rather, they are separate contracts. If you make an error of this nature, you would now be short calls and long puts—a synthetic short futures position. They might not be the best idea, as you can imagine. This trader was short calls.

7. Did he want to buy the options at the market? Did he want a specific price? You must indicate the type order that you are entering. Let's say that he wanted to buy back his short call options at .15 on a limit.

8. Was this order a day order or an open order? All orders are day orders unless otherwise specified. If he wanted this order to be working GTC, that would not have happened in the earlier request. Always specify whether you want the order to be GTC.

There are more possibilities for errors than just these mentioned, but they can also come in the form of enunciation (fif*teen* versus fif*ty* is a common one).

Also, many option orders require you to state whether the position is opening (initiating a position) or closing (liquidating a position). The primary purpose is for the exchange to keep accurate records of the open interest of each strike price.

Let's re-enter this order as it should have been given:

> "I have an open option order, buying calls. Please buy back 10 June live cattle 75 strike call options at 15 (that's one-five) on a limit. To close. Good until canceled."

Let's now count the ways in which this order-entry methodology saved the client a lot of money:

1. "I have an open option order . . ." By starting the sentence with this phrase, we already establish that this order will be GTC *and* that it will be an option order. This fact is a major time saver. The clerk now knows which ticket to grab right from the top (which is a major bonus for order clerks and brokers). Each ticket has a different color code (futures, option, day, or open), and it is helpful if the clerk knows up front upon which ticket he or she should start writing. You will save a lot of time if the clerk does not have to wait until the end of the sentence to figure out that he or she should have written the order on a blue ticket instead of on a yellow one. If that situation occurs, the clerk must rip up the first ticket, rewrite the new one, and ask you to repeat your order to triple check it. Using this phrase will also reduce the likelihood of misinterpretation throughout the rest of the sentence.

2. " . . . buying calls." By saying that you are buying calls at the beginning, the order clerk has two specific advantages. One, he or she can put the pen on the buy side of the option ticket (the left side), and two, he or she can mark the box for calls right away. This phrase again increases the speed of order entry and reduces the likelihood of mistakes as the sentence continues.

3. "Please . . ." Well, being cordial is never a bad thing. Your manners show that you appreciate the job that the clerk does for you, and they just might help you get better attention in the future. Everyone likes to be appreciated.

4. " . . . buy back . . ." In this situation, you are not only stating that you wish to buy the options, but that you are buying options that you were previously short, back. This word is not necessary if you are calling the floor or even a discount desk, but it can trigger a broker to double check your position to be sure that you are indeed short these options and to help prevent an error.

5. " . . . 10 June live cattle 75 call options . . ." You stated the quantity, the month, the specific cattle contract, and the fact that they are call options.

6. " . . . at 15 (that's one-five) . . ." For the purpose of clarity, whenever you say a quantity that might be confused with something else, try to spell it (one-five versus five-oh). Although this practice might seem redundant, the more times you can state your intentions in the sentence, the better.

7. " . . . on a limit . . ." You are clarifying that this order is not a stop, but that it is a limit order. This step is very important in catching mistakes. When a clerk takes a limit order, he or she will often check the last price of the option. Let's say that your data was incorrect or that you read it wrong, and these options were not trading at 20 or 25 as you thought. Rather, they were trading at 5. By stating that this order is a limit order, you will likely cause the clerk or broker to mention that the market is actually at 5 and to ask you, "Do you want this order on a stop or or better?" Wow. That statement right there can save you some money. You now have the choice to change your price or rename it as an or-better. This statement might also alert you to the fact that you might have given the wrong strike price or messed up call versus put, and so on. Whenever you are entering an order and you find that the price is way off what you thought it might be, there is almost always some kind of mistake in the process.

8. " . . . to close . . ." Again, you are stating that this order is a liquidating order. This phrase gives your broker another chance to be certain that you are entering the correct order.

9. "Good until canceled." Here, you give another reminder that this order is an open order. This order is in effect until it is either filled or canceled.

Offsetting order of Client position:
Buy
10
June

Live Cattle
75 strike
Call options at .15 limit
Good Until Cancelled.

You should note that there are significant differences (or at least, there should be) in the quality of service that you get from a discount broker and from a full-service broker. A full-service broker (or at least a professional broker that you pay a small premium with which to trade) earns part of his or her money by helping prevent order-entry mistakes. A professional broker makes it a point to memorize every client's position at the start of the day so that when a customer calls in with some silly request, the broker knows right away to question the order. A discount desk is not paid to keep a mental note of your positions, and it might not notice that you entered the order incorrectly—that is, until your mistake causes a margin call. In this case, the discount desk will contact you right away. (You cannot imagine the adrenaline rush of fear when you get a call asking for margin money when you thought you were flat the market for three days.) Do not make order-entry mistakes. No matter what your intentions, if you enter an order incorrectly, you will be financially responsible for that mistake.

Professional brokers are likely to keep mental or written notes of all of the trades made during the day to help make certain that traders are in the position that they desire by the end of the day. A professional broker will likely keep track of open orders as well. While ultimately, any order that a trader enters is his or her responsibility, it might be worth the extra dollars to work with a broker who might save thousands of investing dollars by preventing a mistake.

Working with a professional broker does not necessarily translate into high commissions, however. Commission fees can range from as low as $12 to as high as $200. Depending on the level of service that you require and the volume of trading that you do, commission fees are negotiable.

How to Take an Order. Learning how to take an order is as important as knowing how to give one. Here are some examples of the questions to ask clients before executing an order:

1. The trader places an order to buy: "You wish to buy—that's purchase—correct?"
2. The client calls in to sell a contract: "You are selling this contract to make money if it is going down, correct?"
3. On every order entered: "Is this an initiating or offsetting position?"
4. If the order seems unusual: "Did you know that this market is trading at XXX price?"
5. If the client usually trades one contract at a time: "You're buying two—that's a pair, correct?"
6. The client is already short the market and calls to sell one at the market: "You are already short one S&P, Mr. Smith; do you mean to liquidate or double up?"

7. The client is short one and places an order to buy two: "You are buying two to reverse and go long, correct?"
8. The client calls in an open order stop and already has one working: "You already have an open order, Ms. Jones; do you wish to cancel that one and replace it with this one?"
9. The client exits a market and still has a stop order working: "You still have an open order working on this trade. Do you wish to cancel it?"(Many, many, many traders forget to cancel open orders, which can result in expensive surprises. Always go through open orders to search for mistakes.)
10. A client trades mini-S&Ps and places an order for a big one: "This is an order to sell a big S&P, is that right?"

Quiz

1. If you wish to protect yourself from falling prices, what type of an order would be the best to use?
2. If you wish to protect yourself from rising prices, what type of order is the best to use?
3. If you wish to buy a market on a dip and you want to be specific about the price, which type of order is best to use?
4. If you wish to catch a breakout higher in the market but are concerned about paying too much, which type of order should you use?
5. If you want to place both a stop and a limit order on a position, which type of order should you choose?
6. If you own an option and would like to sell it if the futures reach a certain price, which type of order would you use?
7. When you liquidate a position, all existing orders for that trade are automatically canceled. (true or false)
8. Once you get to know the broker, you do not have to emphasize order-entry procedures. (true or false)
9. If you wish to sell a market but only wish to do so if it closes below a certain level, which type of order should you choose?
10. All orders are considered to be day orders unless otherwise specified. (true or false)
11. Shorting calls and buying puts are essentially the same thing. (true or false)

Answers

1. A sell stop order. A sell stop order is only executed if the market trades at the stated price or lower.

2. A buy stop order. A buy stop order is an order to buy if the market trades at the stated price or higher.
3. A buy limit order. A buy limit order is placed below market prices and must be filled at the stated price or better (lower).
4. A buy stop limit order is a buy stop with a coinciding limit. This order instructs the broker to buy if the market trades at the stop price or higher but not to pay more than the limit price.
5. An OCO order means that one order cancels the other.
6. A contingency order can only be placed with a professional broker.
7. False. Orders must be canceled separately.
8. False. Working with a broker can have its benefits, but specific procedures must be followed in order to prevent mistakes or miscommunication. A good broker should always educate clients on proper order-entry techniques.
9. A stop close only order is only executed on the close.
10. True. An order that is meant to be GTC must be specified as such.
11. False. They are completely different and do not offset each other. For more information about options, refer to Chapter 8, "Options Trading."

Daily Procedures for Professional Futures Brokers

A broker must take important daily steps in order to ensure that his or her business runs smoothly. Being a broker is the equivalent of running your own business. Every successful business has a plan, a method of enacting that plan, and important rules to follow. The same is true when you become a broker. Brokering is a business that should be taken seriously and should be operated under the highest of ethical standards.

What follows are some examples of a day in the life of a futures broker and a few tips about how to grow a better business:

- Arrive at your office early.
- Check trades from the day before. Be certain that there are no mistakes.
  - Check every fill from the previous day.
  - Be certain that the trade was punched into the account correctly.
  - Check to be sure that the quantity matches both the quantity on the ticket as well as the quantity in the account.
  - Be certain that the trade price matches the fill price.
  - Check to be sure that trades intended to offset positions match.
  - Check to be sure the correct month has been entered.
  - Check every other account for trades that do not belong.
- Margin the run.
  - Confirm that every account has adequate margin for the positions. Make note of those accounts that are under-margined.

    - Look for accounts that are close to margin call. Make a note of the type of market move that might trigger a margin call.
- Check for messages.
- Get ready for the market open.
    - Place all orders that need to be entered.
    - Read the news and examine prices in order to spot any aberrant overnight moves.
    - Call clients who need to know about market moves.
    - Make appropriate margin calls if necessary. Take accurate notes of this procedure.
- Throughout the day
    - Check through entire run and be certain that every client with a position has an appropriate offsetting stop and target.
    - Check through the open orders to be sure there are not any stragglers. Look for orders that are duplicates or that do not seem correct.
    - Keep an eye on the markets and the news. Inform clients of interesting tidbits.
    - Call clients. Do not wait for them to call you.
    - E-mail clients. Keep them abreast of activities.
    - Continue margin calls if needed. Take good notes.
    - Monitor the government reports and their potential implications on market conditions.
    - Check every fill as it comes in. Be certain that the order was entered correctly. Report fills to clients.
    - Check for orders that have not come back in a timely fashion. Confirm that all orders that should be filled have been filled and reported.
    - Check for e-mail and faxes throughout the day.
- After the close
    - Do your technical analysis. Generate support and resistance zones. Evaluate the market for trading opportunities. Communicate your findings to clients.
    - Go through all order tickets. Be certain that all orders that should have been filled were filled. Check the open orders, as well.
    - Margin the run. Look for clients that are close to margin call. Make note of the markets in which they reside. Call the client if appropriate.
    - Send out a daily summary or newsletter.

Chapter 6

Analysis: Tools and Theories

Introduction

Market analysis has been around for a long time. Traders study supply and demand, chart patterns, and even astrology in the hopes of gaining an edge over the competition. A different tool exists for every trader, and some tools work better for one than for another. The key to market analysis is determining which tool will work best for you. In this chapter, we list many of the most popular means of trading analysis, along with a unique approach that people seldom discuss.

Zero-Sum Game

Futures trading is a zero-sum game. For every buyer, there is a seller. For every trading dollar lost, there is a dollar gained (see Figure 6-1). Every person who buys or sells a contract is doing so with the belief that he or she is right about the market.

Imagine a transaction between buyer and seller where gold trades at $300 per ounce:

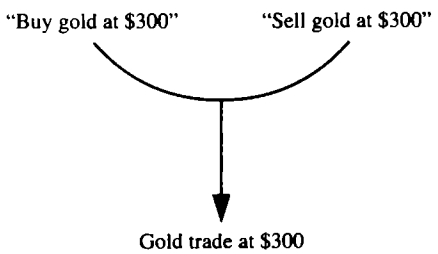
The buyer of the gold contract might be establishing a long position with the firm belief that the market is headed higher. The buyer of that contract could also be buying in order to offset a short position. In either case, he or she does not believe that gold will go much lower (or is, at least, vulnerable to a turnaround).

The seller of the contract does so with the firm belief that the gold will go down in price. If not initiating a position, the seller of a contract could be offsetting a long position. In either case, the seller has the firm belief that the market is not likely to go higher (or might even turn around).

Both traders reviewed their work and determined that the trade was appropriate for that time and price. How is it that two individuals can arrive at two different views of the market, however? The answer is that no answer exists.

The market is its own free-flowing beast, not unlike waves in the ocean. Whether or not we choose to navigate them, they will always exist. How you choose to approach these waves is what determines your success or failure as a trader.

Figure 6-1 *Zero-sum game*



Imagine the giant waves of Hawaii, which are intimidating to most people. But the skilled surfer rides the waves with an elegant flow. The surfer has learned to let the power of the wave work in his or her favor. You can take the same approach with the markets. By learning to master the ebb and flow, you can get the market to work to your financial advantage.

Sometimes the seas are calm, with gentle swells and easy-flowing waves. Sometimes the seas are violent, with sharp peaks and troughs. We can choose to participate during those times, or we can choose to stand aside. The market, like the ocean, is not influenced by what we choose to do. In fact, the market has no feelings at all. The market takes no prisoners and has no regrets.

Success in the marketplace has nothing to do with the size of the peaks and valleys; instead, it has everything to do with how we choose to ride the waves.

Of course, we cannot forget the middleman—the brokers and clearing houses that take their little piece from the top. Some trading dollars are lost to fees and are not recaptured in the market elsewhere.

Fundamental Analysis

No magic formula exists when it comes to analyzing the market. Fundamental analysis is one way to evaluate whether a market is likely to go higher or lower. Fundamental analysis refers to those elements that affect the physical supply and demand. Trades are placed in the futures markets based on the flow of supply and demand in the cash markets.

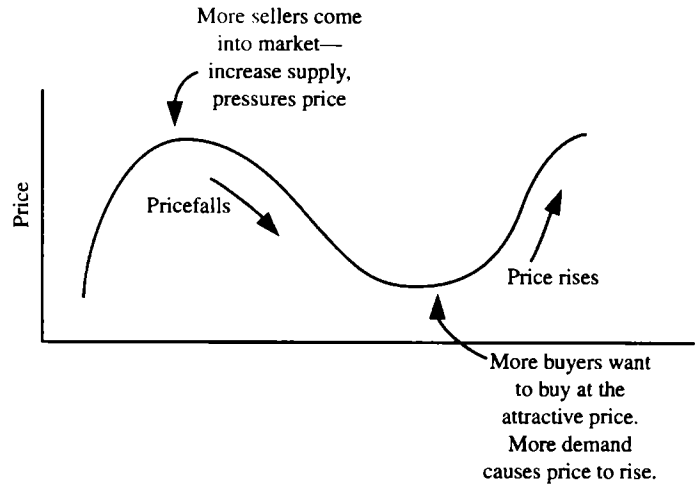
Supply

The supply of commodity items is made up of 1) the current year's production, 2) carryover from the previous year's production, and 3) imports. For example, a commodity such as gold is mined in the United States throughout the year, stored in vaults for future use, and imported to other countries in order to meet domestic demand. Some commodities are perishable and cannot be stored year after year, but in general, carryover inventory is an important part of supply.

Obtaining information about physical supply is not easy for the average investor. The grain market is one in which reports are available to the public that depict the current supply of the market. Examples are the Prospective Plantings report (released on the last trading day of March), Monthly Crop Production reports (released during the prime growing season), and winter Grain Stocks (released in January and at the end of March). Most data services have this information on the news wires.

Current supply numbers can give the fundamental analyst several clues about future prices. One clue is the amount of product that is being made available on the current market. The price of a commodity is cyclical. If the price tends to rise, more sellers are willing to capture the rise in price and subsequently put more product up for sale at that time. By watching the flow of product that is available for sale, the fundamental

Figure 6-2 *Supply and demand—a cyclical event*



analyst can get an idea of the seller's view of future prices. If the seller is more willing to sell the product on hand, that means that he or she anticipates prices to fall in the future. The seller is trying to capture the higher price (see Figure 6-2).

A seller's willingness to sell is based not only on price, but also on the storage capability of the product. If a product cannot be stored for the next year, or if it is perceived to be too expensive to store, a seller might choose to dump the product on the market at the first good opportunity.

Other factors that influence supply are the weather, number of acres planted, birthing rates of livestock, and the yield per unit. Ideally, when evaluating supply, you must consider not only the number of acres planted or hogs that are born but the quality of the product. For example, even if a farmer planted a full field, if the weather was poor and the yields were low, the effective supply would also be low.

Still other influences on supply are the number of producers, millers, and refiners, the operating capacity of these facilities, the relative costs of production, and the political influences on production. For example, the ability to drill for oil, the cost of equipment, the efficiency of the refiners, and the production quotas as set by OPEC affect the supply of crude oil. The *Organization of Petroleum Exporting Countries* (OPEC) sets the daily quotas of the major oil-producing nations.)

As you can see, the factors that affect supply are complex. You cannot really capture every nuance that affects the supply, but you can follow the major influences and formulate an opinion based on the findings.

Demand

Demand, by definition, is the quantity of a product that buyers are willing to buy at a given price. Normally, demand goes up when prices are low (people are willing to buy more at a lower price), and demand goes down when prices are high (people are not willing to buy as much at the higher price).

Some products are more sensitive to price than others. For example, if the price of a bag of potato chips were to rise by $1, you might be more reluctant to buy the bag. Or, maybe you would choose to buy pretzels instead. If the price of a gallon of milk were to rise $1, however, you might still buy the milk because there are fewer substitutes. Also, milk tends to be a staple food item. Income, population, available substitutes, and personal tastes and preferences affect the demand for goods and services.

Advertising largely affects tastes and preferences, which is why you see so many commercials for milk ("It does a body good"), eggs ("Give us a break"), pork ("The other white meat"), and beef ("It's what's for dinner"). These sectors of the agricultural community want to keep the demand for their products from dwindling, despite what you might hear about salmonella poisoning, cholesterol levels, and Mad Cow disease.

When you have a product such as corn or soybeans, demand is usually influenced by the following factors:

1. Livestock reports. Because cattle, hogs, and chickens are major consumers of corn and soybean meal, the population of livestock influences demand.
2. Foreign purchases. Traders watch other countries (such as China and the former Soviet Union) in order to assess their potential import demand. Population growth rates, domestic production, and economic strength are monitored to determine a country's need and capability to buy agricultural products.

Many different levels exist where supply and demand factors can influence prices in the commodities markets. Sometimes, a short-term glitch in the chain of distribution of corn will affect prices at a local mill but will not influence prices at the *Chicago Board of Trade* (CBOT). There can also be a surge in prices at the exchanges that the consumer does not feel. For example, coffee prices at the futures exchange might rocket higher because of fears of a damaging freeze, but the price of coffee at the store will not change. This situation is largely due to the fact that 1) the price surge was temporary, and 2) coffee farmers and millers were hedged in the futures market to protect themselves from gyrations and were therefore able to absorb a short-term run in prices.

How to Obtain Fundamental Information

Unfortunately, supply and demand information about the cash markets is not readily available to the average investor. Some reports mentioned previously are released to the public, but in general, the information does not extend beyond that level. Research firms and large brokerage houses have access to the data and can provide this information as a service. Some data providers also include cash market prices. Exchanges also can provide valuable data about market statistics. To get extensive information, you will have to do some digging.

Commercial agricultural firms such as Cargill or *Archer Daniels Midland* (ADM), conduct extensive research to determine the expected flows of supply and demand. They place positions in the futures markets based

on this research, in order to hedge themselves from dramatic price increases and decreases. One way to benefit from this research is to simply follow what these large commercial firms do.

All participants who have large positions in the commodities markets have to report these positions to the *Commodity Futures Trading Commission* (CFTC) at the end of each day. The CFTC releases this data two times per month. By monitoring the positions of the commercial traders and large speculators, you can get a good grasp of what these professional firms think about future market conditions. While the data are slightly behind the market and are by no means specific indicators of prices, the information does give an idea about the bullishness or bearishness of the professional community.

Technical Analysis[1]

If you plan to take your trading seriously, I strongly recommend that you study *Technical Analysis of the Futures Markets* by John J. Murphy. This book sets the foundation of what there is to know about charting and market action. This book is commonly referred to as "the Bible" of technical analysis. Read it, know it, and refer to it often.

The philosophy of technical analysis, as described by Murphy, is based on three major premises:

1. Market action discounts everything.
2. Prices move in trends.
3. History repeats itself.

Market Action Discounts Everything

Future prices are affected by the fundamentals of the cash market, political lobbies, psychology, and more. The technician believes that anything that could move the commodities markets is already reflected in the price. The technician believes that price action is all that needs to be studied for successful trading.

Price action reflects the shifts of supply and demand. If the demand exceeds the supply, prices rise. If the supply is greater than the demand, prices fall. Therefore, if prices are rising, the demand must exceed the supply—and the fundamentals must be bullish. Conversely, if prices are falling, the fundamentals must be bearish. By studying price action, you are in effect studying the fundamentals. Murphy points out that supply and demand cause bull and bear markets, not the charts themselves.

Because everything that can affect a market is already reflected in the price, the technician does not need to be concerned about the fundamentals, per se. Rather, the technician should let the market action tell the trader which way the market is likely to go.

[1]Charts in this chapter provided by CTS Financial Publishing: *Technical Analysis of Futures Market* by John Murphy and *Speculating in Futures* by The Chicago Board of Trade.

Prices Move in Trends

The success of trading commodities is to spot a developing trend and ride it until it ends. Considering the laws of motion, a market that is trending is more likely to continue that direction than it is to reverse. A market will trend until it finds either a new level of equilibrium or a reason to reverse.

History Repeats Itself

Although the commodity markets have evolved over time, the one thing that has remained the same are the people who trade them. Price action still reflects bullishness and bearishness of the participants in the same manner. Markets still surge on rumors and fall back after the fact. People still get in early or take a loss too far. Beans still rally on drought fears and sell off when it rains. The psychology of the marketplace has not changed. This fact causes history to repeat itself. As long as people are involved in the markets, the past will continue to be an excellent map for the future.

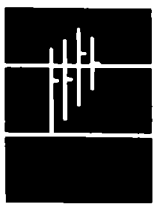
Technical Indicators—Simple Geometry

Chartists believe that price behavior follows consistent patterns that have predictive power. The most common way to record price action is through bar charts. A price bar chart consists of the high, the low, and the close. Many traders believe that the open should be ignored when predicting market action. A line is drawn between the high and low of a certain time period, and a hatch mark indicates the close. Price bar charts are made for the day, the week, and the month. Shorter-term traders might chart the high, the low, and the close of each hour (or each half-hour and even every five minutes) to try to predict the next trend in the market.

The first thing to consider about bar charts is how each bar chart relates to the other. There are four major categories concerning this relationship:

1. Inside day: This situation occurs when the high, low, and close are within the range of trading of the previous day. The technician will use this pattern and monitor for a breakout of this pattern the following day. Typically, a break above the high of the inside day is bullish, and a break below the low of an inside day is bearish (see Figure 6-3).

Figure 6-3 *Inside day*



2. Outside day: This situation occurs when the high and low of the current trading day exceeds those of the previous day. If the close of the current day is higher than the close of the previous day, it is a bullish signal. If the close of the outside day is below the close of the previous day, it is a bearish signal (see Figure 6-4).
3. Closing price reversal: This situation occurs when a market has been trending in one direction (up or down), and sometimes one price bar might indicate a change in the trend. When a market has been moving higher and then one day makes a new high and closes below the close of the previous day, the uptrend might be ending. When a market has been trending lower and then one day makes a new low and closes above the previous day's close, the downtrend might be about to end (see Figure 6-5).
4. Key reversal pattern: This situation occurs when a market exceeds the range of the previous day and closes at one extreme, which is against the trend. For example, in an uptrend, the market makes a new high *and* closes below the low of the previous day. Or, as in a downtrend, the market makes a new low and then closes above the previous day's high. These patterns often entice traders to exit their trade or even reverse their position (see Figure 6-6).

Trading Definitions

Support—An area where there is enough buying pressure to halt a decline

Figure 6-4 *Outside day*

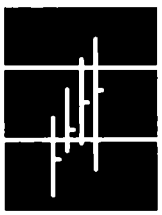


Figure 6-5 *Closing price reversal*

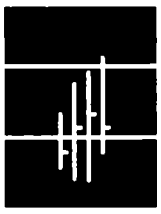


Figure 6-6 *Key reversal*

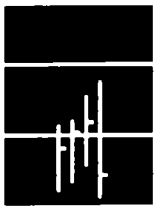
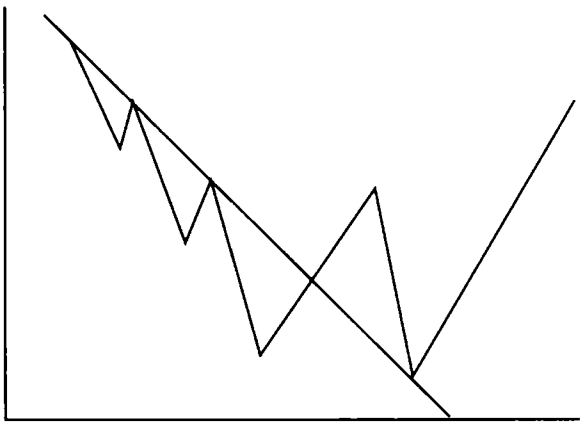


Figure 6-7 *Trendline*



Resistance—An area in which selling pressure is expected to halt an advance

Equilibrium—When a market trades in a narrow range for a long period of time, it is said to be at equilibrium. The current conditions warrant a stable price level for a commodity. Often, a market that is at equilibrium is said to be consolidating, in congestion, or coiling. Trading opportunities occur when sufficient market forces cause a market to break out from a congested area. Usually, a market will begin a trend until it finds another area of equilibrium.

Uptrend—A series of higher highs and higher lows signifies an uptrend.

Downtrend—A series of lower highs and lower lows signifies a downtrend.

Trendline—A trendline is drawn to connect a series of higher lows (uptrend) or lower highs (downtrend). Typically, a trendline is valid if it connects three or more points. A trendline serves as support (uptrend) or resistance (downtrend). If the market breaches the trendline, the trend is said to have been broken (see Figure 6-7).

Bull market—This situation occurs when prices are generally appreciating. Each movement to the upside reaches a higher level than the previous move, and each retracement (or counter-trend move) halts at a higher level than the previous retracement. A bull market can also be defined in futures

trading when the front month of a series is trading at a higher price than the back months, indicating a lack of supply or excessive demand for a product in the near term. Usually, commodity prices are higher in the later months to reflect the cost of storage or interest rates and are called carrying charges (also called an inverted market or backwardization). Interest-rate products are one futures contract that does not abide by this rule. In general, the interest rate futures contracts are inverted in normal market conditions.

Bear market—This situation occurs when prices are generally falling. Each move to the downside is lower than the previous move. Each retracement, or secondary price move, is at a lower level than the previous move. The nearby futures contracts are generally at lower prices, indicating a glut of supply in the near term. (Again, this situation does not apply to interest-rate contracts.)

Major Tops and Bottoms

Head-and-shoulders pattern—Just as the name implies, a head-and-shoulders pattern resembles the look of a left shoulder, a head, and a right shoulder. A market that has been trending higher is typically indicating a reversal when this pattern develops. A market makes a high (left shoulder), rounds off, guns to a higher high (head), rounds off again, then attempts to make another high (right shoulder) but falls short and rounds off. A top is not in place until prices then penetrate the neckline (see Figure 6-8).

Neckline—The neckline of a head-and-shoulders pattern is identified by connecting the two lowest prices that form the head. If they are not equal, the neckline is defined as the lowest of the two prices that helped form the head.

Inverted head-and-shoulders pattern—This pattern typically signifies the reversal of a downtrend. The same pattern develops, only it is upside down. The market makes a low (left shoulder), retraces, makes another low (head), retraces, attempts to make another low (right shoulder), and then trades higher. The neckline is broken by breaking the higher price that surrounds the head (see Figure 6-9).

Target level—Most technicians say that a reasonable target for a completed head-and-shoulder reversal pattern is the distance between the top of the head and the neckline, in the direction of the breakout.

Double top—A double top is two attempts of equal magnitude to make new highs. A double top is in place if the market breaks below the most recent retracement (see Figure 6-10).

Double bottom—A double bottom refers to two attempts at new lows and a higher reaction that breaks through the recent retracement level (see Figure 6-11).

Rounded top or rounded bottom—When a market makes a long, sweeping move along the highs (top) or the lows (bottom) of a long-term trend, you have a rounded top or rounded bottom situation. Often, this event signifies the beginning of a major move (see Figure 6-12).

Figure 6-8 *Head-and-shoulders pattern*

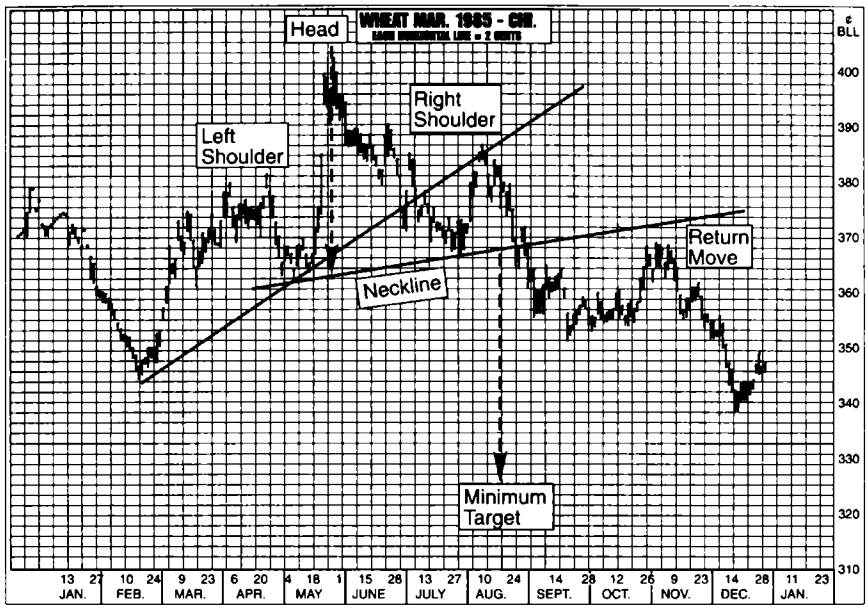


Figure 6-9 *Inverted head-and-shoulders pattern*

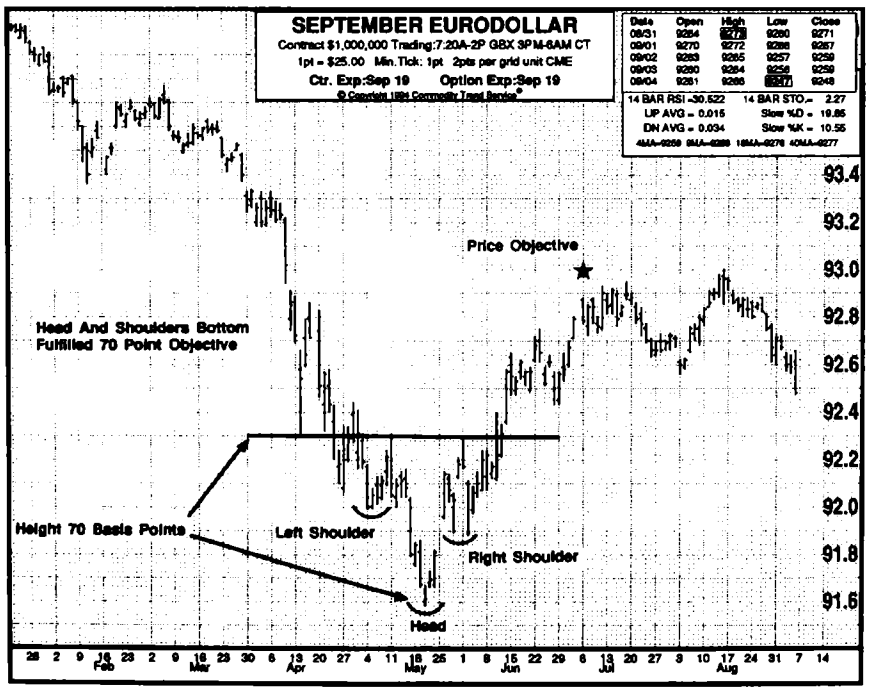
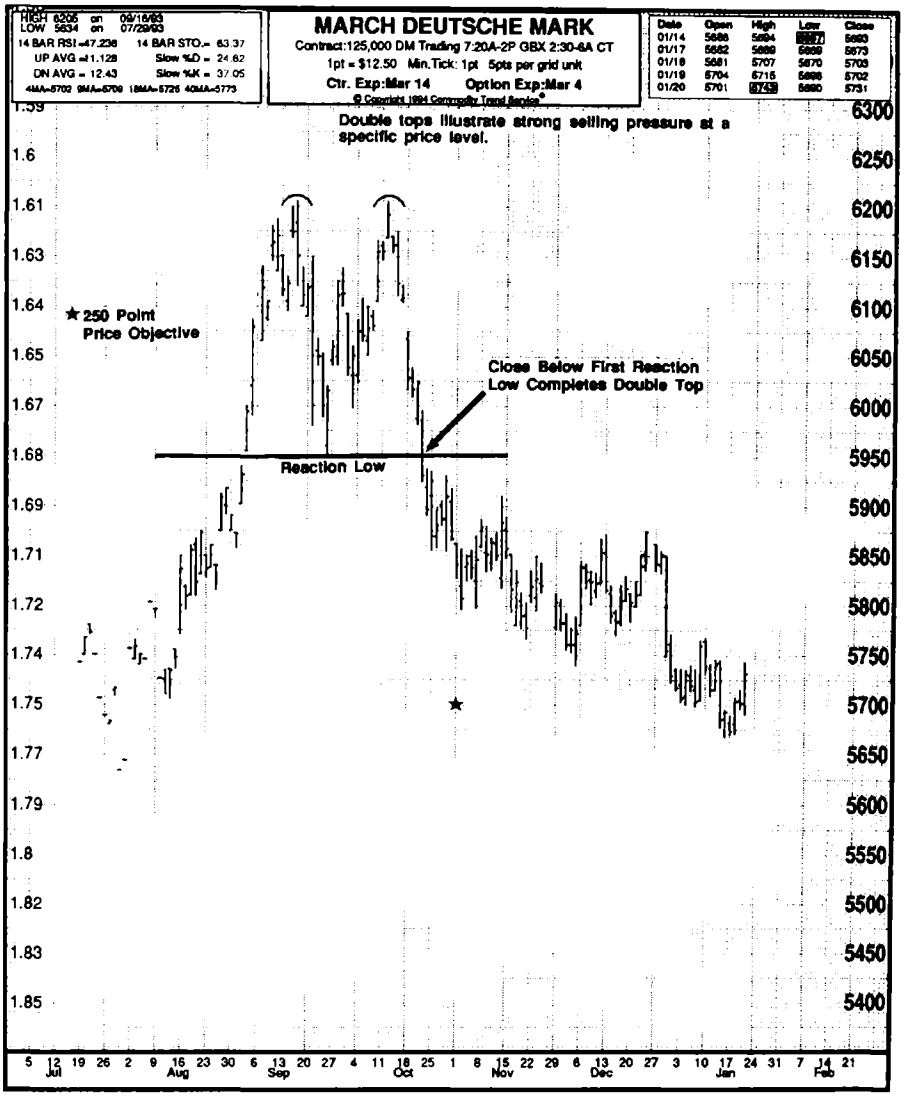


Figure 6-10 *Double top*



Gaps

Gaps are price ranges on a chart where no actual trading took place. There are several types of gaps:

Common gaps—Common gaps appear at any time with no significance. A market usually comes back and fills the gap by trading within that price range within a few days. The market is in a period of consolidation and has gaps in price occasionally in the difference between the open and close of two periods (see Figure 6-13).

Figure 6-11 *Double bottom*

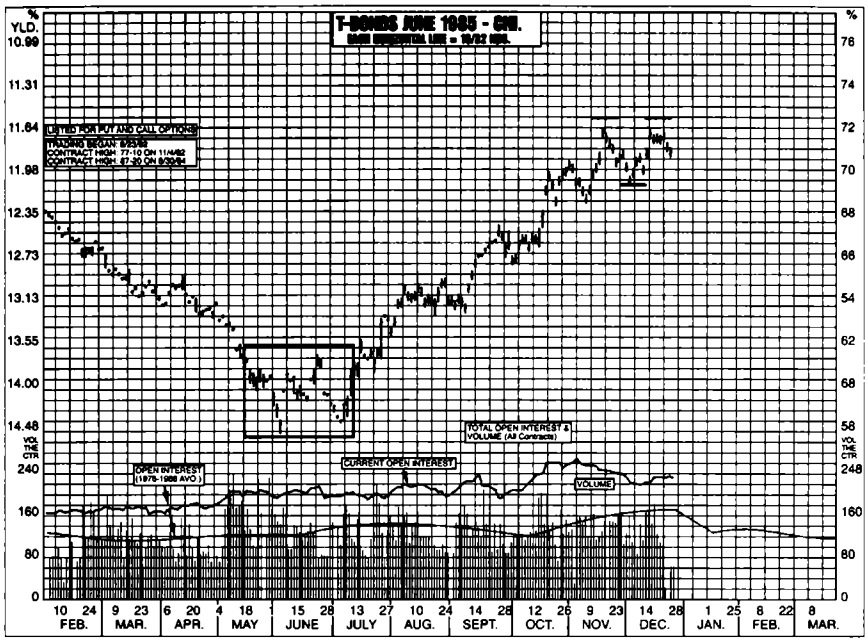


Figure 6-12 *Rounded top and bottom*

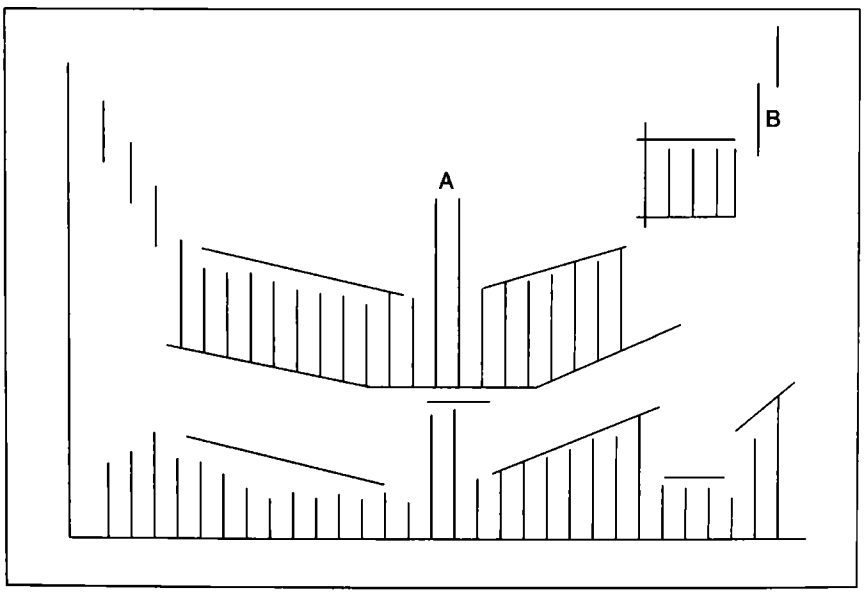
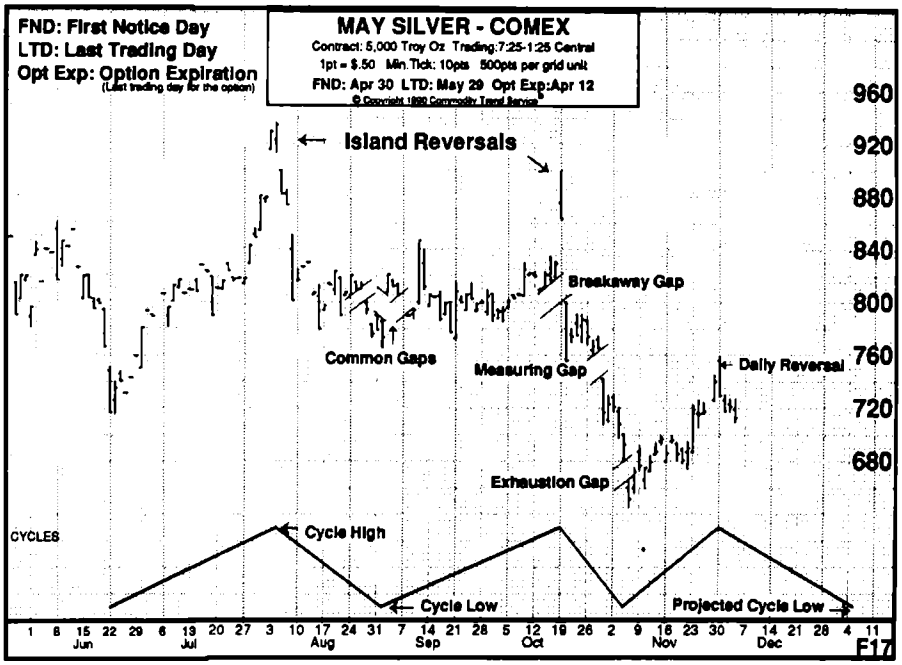


Figure 6-13 *Gaps*



Breakaway gaps—These gaps predict the end of a consolidation. A true breakaway gap signals the beginning of a rapid price move in one direction. Breakaway gaps occur as breakouts of an equilibrium price period.

Runaway gaps—After a trend is established, gaps in price often indicate the midpoint of the move. This action signifies that a powerful trend is intact, especially if accompanied by a surge in volume or a limit move.

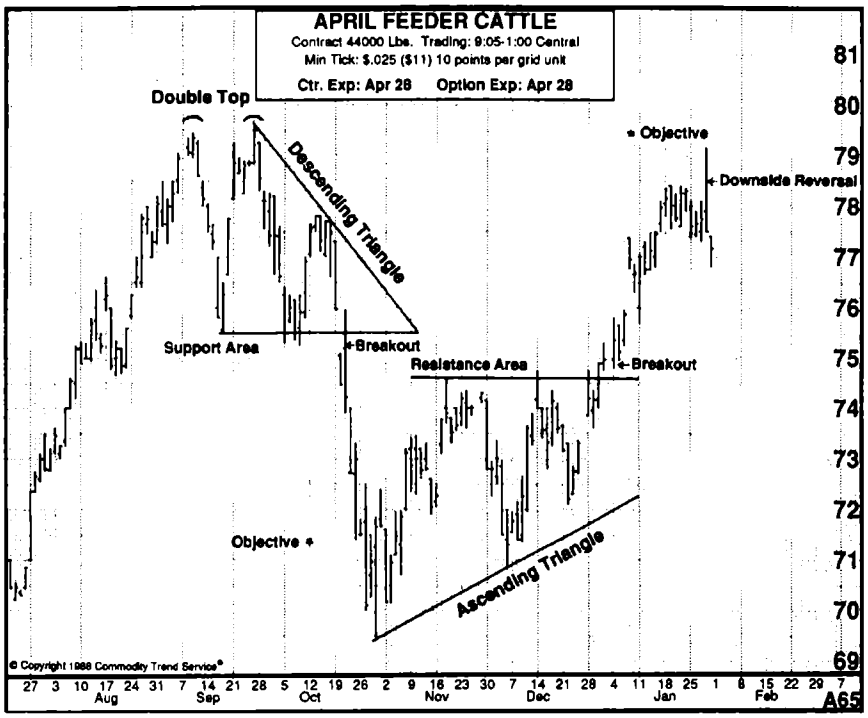
Exhaustion gap—An exhaustion gap often signifies the end of a trend. A market might reverse its price trend within a few days of an exhaustion gap. Essentially, the trend has exhausted itself on that last move up or down.

Triangles

Ascending triangle—An ascending triangle points to a breakout to the upside of the triangle area. The triangle is created by connecting the lows of a recent up move to the line drawn between the highs. An ascending triangle is identified by the flatness of the neighboring highs. A breakout occurs when prices trade above the resistance area (recent highs). See Figure 6-14.

Descending triangle — Signifies that a breakout to the downside might occur. The recent highs are downward sloping, and the lows are basically

Figure 6-14 *Ascending triangle*



flat or even. A breakout is identified when prices trade below the support area (recent lows).

Symmetrical triangle — Also referred to as a pennant, a symmetrical triangle occurs when prices converge to a central point and is identified by both descending highs and ascending lows. A symmetrical triangle indicates that a major move out of a congestive phase might take place.

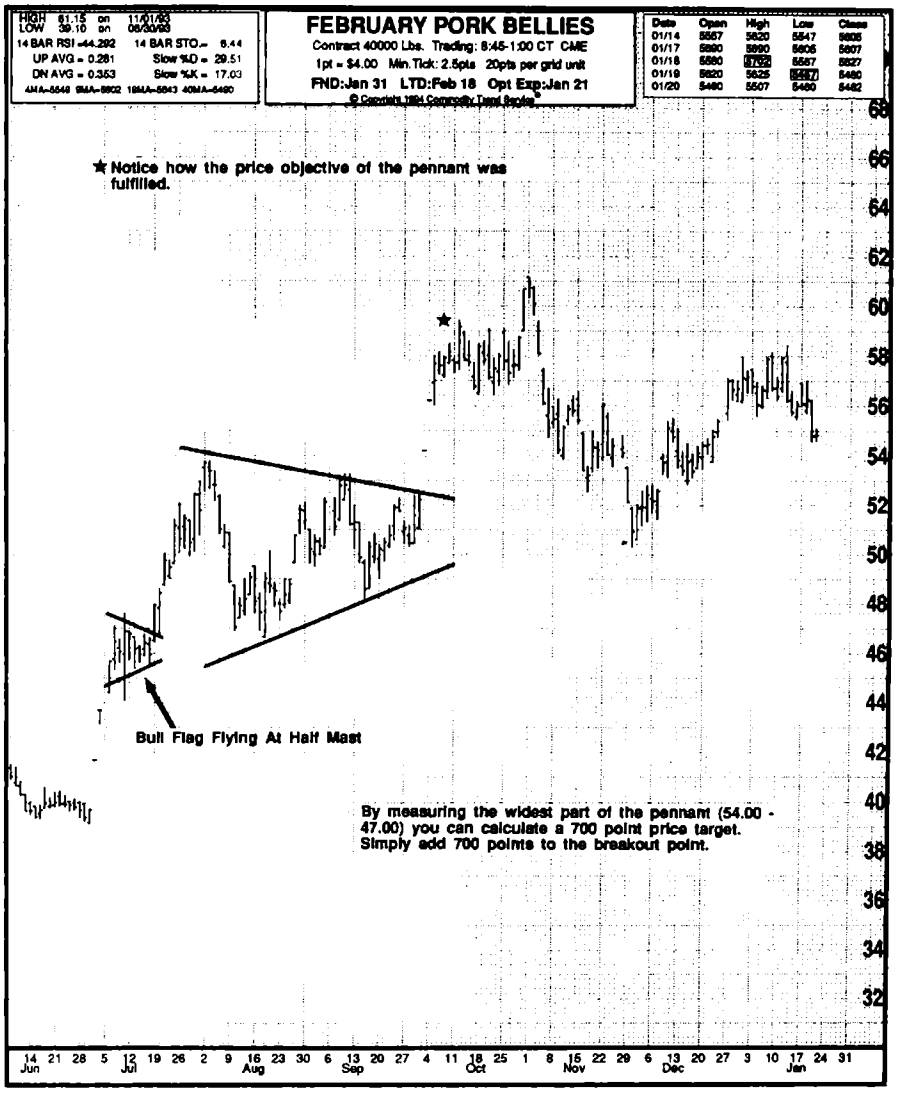
Target points—The point value of the widest range of a triangle often signifies the objective point. When a breakout occurs, it is likely to travel the distance of the width of the formation.

Flags

Flags are small parallelograms that often form just after a rapid price move. They represent a time for the market to breathe before continuing its move. Flags are called such because of the appearance of a pole (swift price move) and a small trading range that follows (flag).

Bull flag—After a quick move higher, the market calms and pulls back slightly, creating a downward drift that lasts for several periods. The market

Figure 6-15 *Flags*



makes lower highs and lower lows in a tight trading range. The market usually breaks out higher after a bull-flag formation (see Figure 6-15).

Bear flag—After a quick move lower, the market consolidates and drifts higher in a small trading range. The market usually breaks out of a bear-flag formation and heads lower.

Target level—Flags have two relatively predictable functions: 1) they often occur at the midpoint of a move, and 2) the target price is consequently the length of the pole (first leg of the move) added to the breakout point.

Technical Indicators—Mathematical Oscillators

Moving Average

One of the most basic and also most effective means of evaluating market movement and trends is the moving average. The effectiveness is due to the fact that a moving average is a flexible trendline that smoothes out irregular movements. A moving average is calculated by adding the average price of a commodity over a number of periods, then dividing by the number of periods:

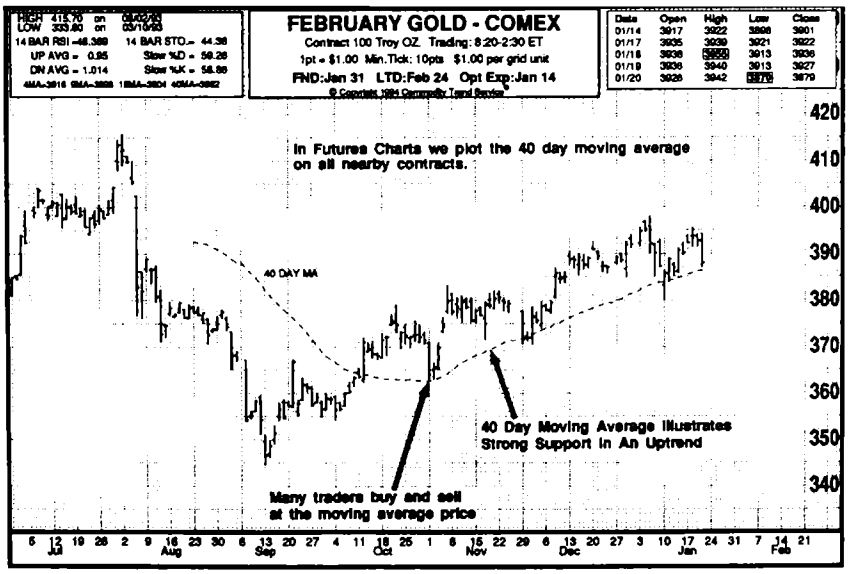
$$MA = (A (t - 1) + A (t - 2) + A (t - 3) + \ldots At) / t$$

A equals the average price for one bar ((high + low + close)/3), and T equals the number of time periods chosen.

By adding the most current average and dropping the farthest-away average, the result is a line that reflects the momentum of the market. A flat moving average indicates a market in equilibrium, and a sloping moving average reflects a trending market.

You can create moving averages for any length of time: 40 days, 18 days, 60 minutes, and so on. Choose the moving average that best reflects the time frame within which you wish to trade. Popular averages are the 40 day, 18 day, 9 day, and 4 day (see Figure 6-16).

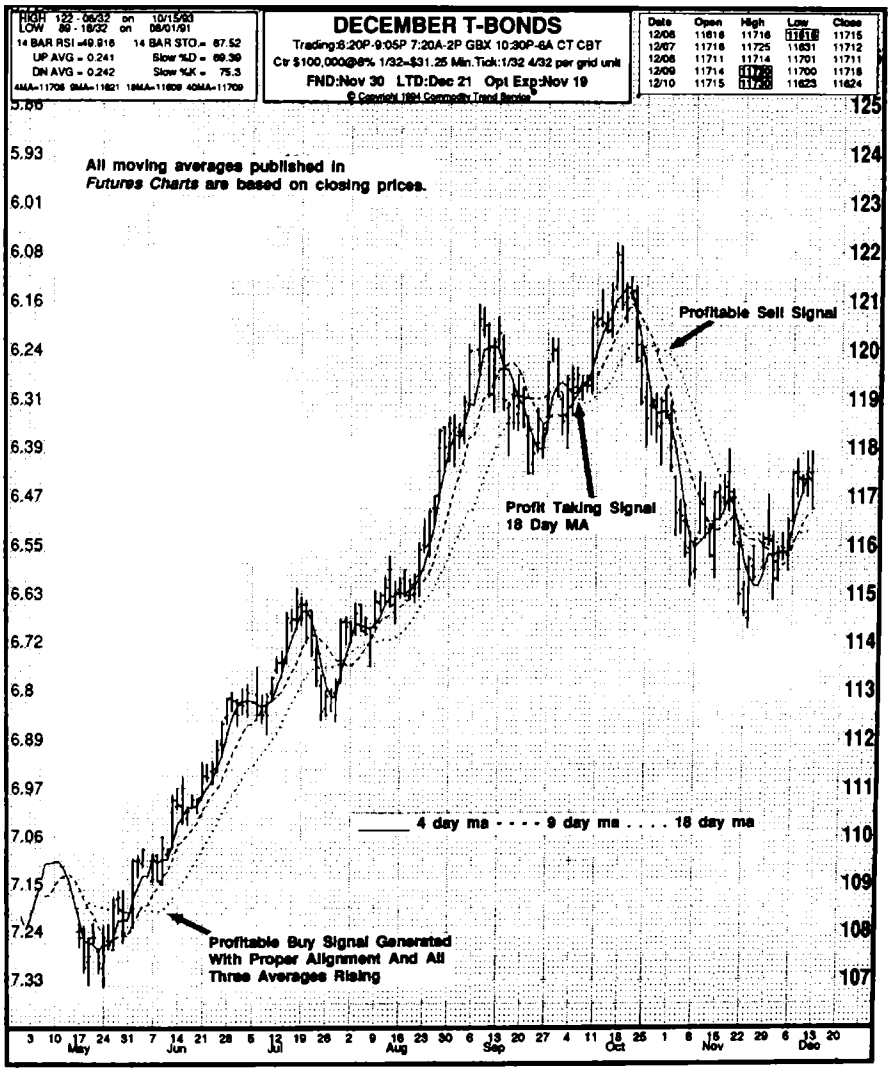
Figure 6-16 *Moving average*



Moving Average Crossover

Typically, a moving average crossover is a combination of two or three moving averages. A buy signal is generated when the shorter-term averages cross the longer-term average from below. Every average must be rising. A sell signal results when the shorter-term averages cross the longer-term averages from above. Every average must face downward. The moving average crossover is an excellent guide for determining when a market is trending but does not work well when the market is congesting (it will flip back and forth until a new trend is established). A popular combination is the 4-, 9-, and 18-period moving average group (see Figure 6-17).

Figure 6-17 *Moving average crossover*



Stochastics

One of the most popular oscillators in use today, stochastics consist of two lines that are based on the rate of change in the close relative to the high and the low. The idea is that as a market is trending higher, each close will be closest to the high of the range. As prices move lower, the closes will be close to the low end of the daily range. Stochastics can be used on any time period, from weekly, daily, hourly, and even down to every five minutes.

Although most charting services have a stochastics function, you should understand how the oscillator is formulated.

Three values must be calculated in order to generate a stochastics chart: the raw value, %K, and %D. These values are plotted on a scale of 0 to 100.

Fast Stochastic. The fast stochastic is usually an erratic indicator and includes the raw value and %K only.

Slow Stochastic. A smoother indicator, the slow stochastic includes the values of %K and %D, which are usually calculated over 14 periods. %K is the faster line, and %D is a smoothed, three-day moving average of %K.

You do not have to try this calculation by hand, because virtually every charting service will perform this calculation. If you must torture yourself, you can purchase technical books concerning this matter. The most famous book is *Using Stochastics, Cycles and R. S. I. to the Moment of Decision* by the founder of stochastics, George C. Lane (Investment Educators, 1986).

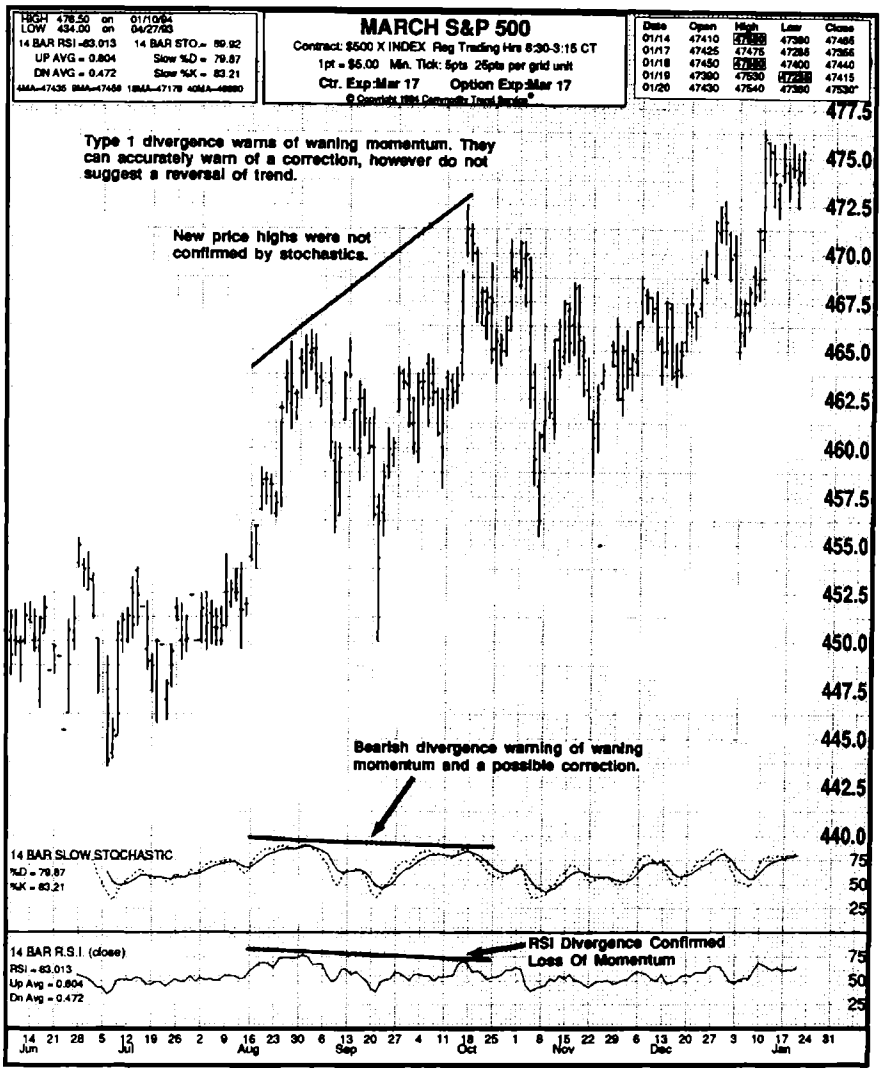
In general, a market is said to be overbought if the value of %K and %D is higher than 75. A market is said to be oversold if %K and %D are below 25.

Stochastic Signals: Look for Divergence.

Style 1. This style helps identify near-term bottoms and tops. Stochastic lines diverge in order to warn of a potential top or bottom. If prices make a new high but stochastics do not exceed their previous high and %K crosses %D from above, a sell signal results. A buy signal results when the market makes a new low but stochastics fail to exceed their previous low, and %K crosses %D from below. This indicator, while not perfect, can be quite powerful in identifying near-term tops and bottoms. This indicator is most effective if the divergence occurs in the overbought or oversold region.

Style 2. This style helps identify a resumption of trend. When a market is trending and then undergoes a corrective phase, stochastics signal the resumption of trend. If a market is setting back from a previous uptrend and the stochastics make a low below the most recent low, as long as the overall trend is still intact, a new buy signal is generated when %K crosses %D from below. Conversely, if a market is trending lower, pauses for a while, and then stochastic lines make a new high above their previous high, as long as the general downtrend is still intact, a new sell signal results if %K crosses %D from above (see Figure 6-18).

Figure 6-18 *Stochastics*



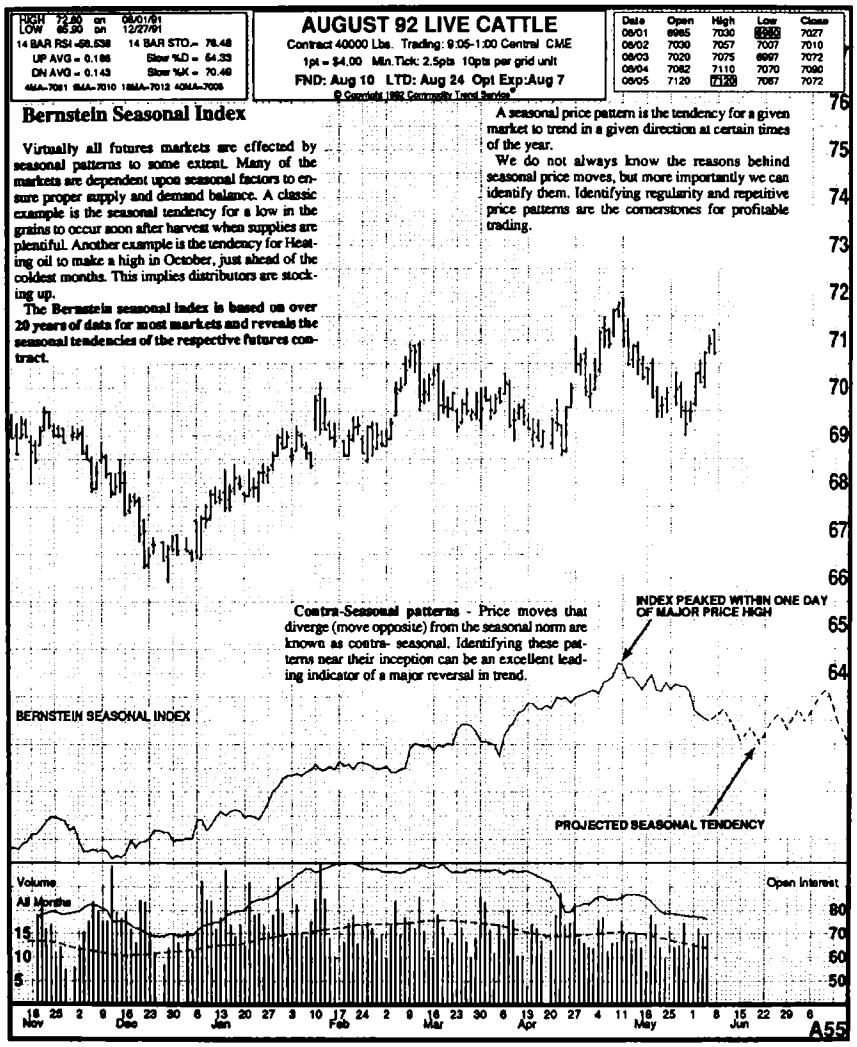
Moving Average Convergence/ Divergence (MACD)

MACD assists with identifying whether price action is a short-term deviation or a structural change in the trend. MACD is the difference between a fast exponential moving average and a slow exponential moving average. When the fast line crosses the slow line from below, a buy signal results. When the fast line crosses the slow line from above, a sell signal results.

Relative Strength Index (RSI)

The RSI is an overbought/oversold indicator that estimates the current strength or weakness of a market during a certain period. Higher closes indicate strength, whereas lower closes indicate weakness. RSI calculates the sum of all up closes and the sum of all down closes within a selected period. The most common number of periods is 14. The typical overbought level occurs when the value of RSI is higher than 70, and the oversold level results when the value of RSI is below 30. A market commonly remains overbought or oversold for long periods of time, however. See Figure 6-19.

Figure 6-19



Volume and Open Interest

Volume and open interest reflect the level of participation in the market. When volume is high, a large number of contracts exchanged hands. When volume is low, the current market conditions are quiet. Open interest is best described as the number of open positions in the market, which demonstrates the level of interest or participation in that contract. In general, you should only trade in contracts that have sufficient volume and open interest. In general, the market will be more liquid and consequently easier to trade.

Volume and open interest also reveal some specific clues about future market action, the details of which Murphy describes in great detail in his book. We summarize the main points as follows.

Volume

Volume refers to the number of contracts traded during a specified time period. Each unit of volume represents a contract traded and includes both the long and the short side of the trade. Volume is typically quoted on a daily basis but can also be used on weekly charts. When monitoring volume, be certain to monitor the total volume of contracts traded—not just the volume of a specific delivery month.

Volume represents the sense of urgency behind a price move. When an extraordinary amount of contracts exchange hands in a day, volume validates the price action of that day. If a market makes a large move that is not supported by a surge in volume, often that move is not to be trusted. Strong volume helps reaffirm the current price trend. If a market has been trending higher and volume begins to taper off as the market is making a new high, the trend might be near an end. (Similar to stochastics, traders monitor volume for signs of divergence as a warning of near-term highs or lows.)

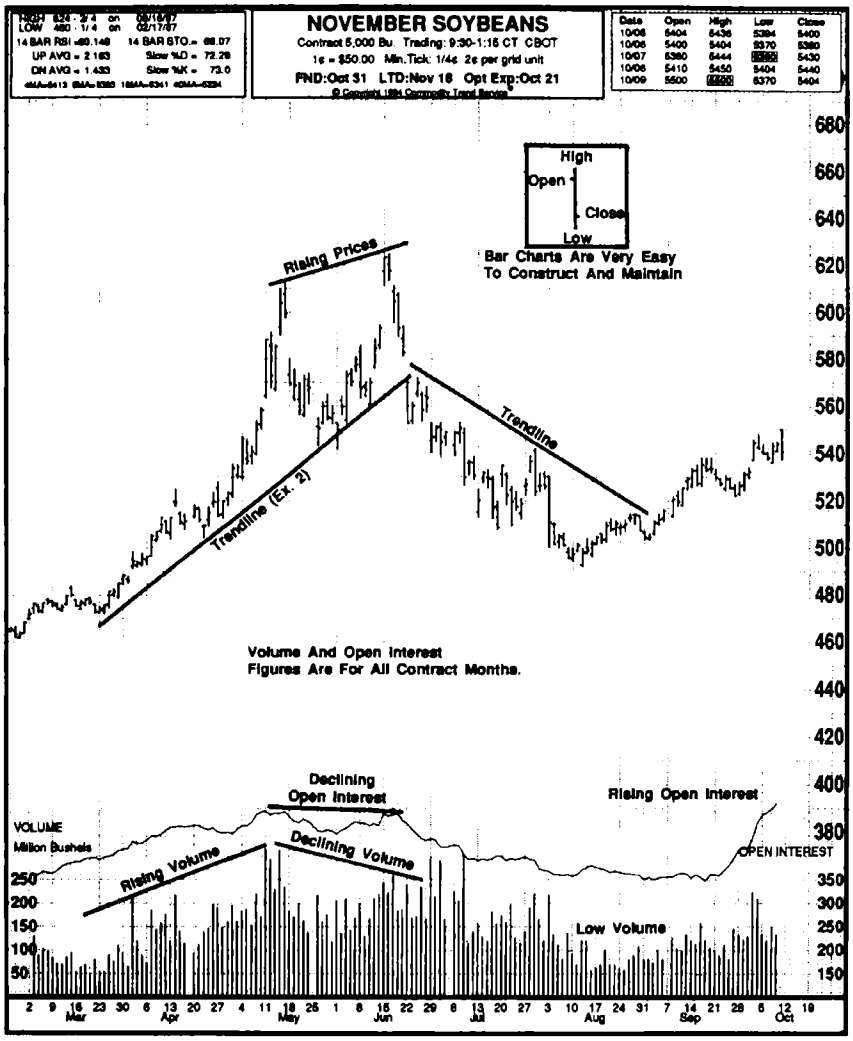
You can use volume in conjunction with many other types of indicators. For example, if the market appears to be forming a head-and-shoulders top and volume is declining as prices create the right shoulder, you should confirm whether a top is in place. If prices then break below the neckline and volume increases, it will confirm that prices are falling with renewed selling pressure. In general, volume should increase in the direction of the prevailing trend.

Volume is known to precede price at major market turns. Often, volume will begin to fade before prices turn around (see Figure 6-20).

Open Interest

Open interest is defined as the number of futures positions that remain open, or unliquidated, at the end of the trading day. Open interest is the total number of outstanding longs or outstanding shorts, but not the sum

Figure 6-20 *Volume*



of both. Every contract has a buyer and a seller, and when combined, they create only one contract.

Open interest is affected by daily price action in one of three ways: 1) it increases, 2) it decreases, or 3) it remains the same. Open interest increases when the number of open positions increases. For example, if a large number of new buyers come into the market, open interest increases. If a large number of new sellers come into the market, open interest also increases. Open interest decreases if positions are being liquidated during the day. Table 6-1 depicts how open interest can change by the end of the day.

Table 6-1

Buyer	Seller	Net Change in OI
Buys new long	Sells new short	Increases
Buys new long	Sells old long	No change
Buys old short	Sells new short	No change
Buys old short	Sells old long	Decreases

If both participants are initiating a position, open interest will increase. If one trader is initiating a position but the other is liquidating, open interest remains unchanged. If both parties are liquidating, then open interest declines. Open interest provides the trader with an idea of whether market movement is due to new money coming into the market or old money leaving the market. Where the money is moving reflects the strength or weakness behind the current trend.

In general, rising open interest in an uptrend is bullish. Declining open interest in an uptrend is bearish. Rising open interest in a downtrend is bearish. Declining open interest in a downtrend is bullish.

Using Volume and Open Interest Together

Both volume and open interest reflect the level of participation in the market, and when used together, they paint a clear picture of the buying or selling pressure that is prevailing (see Table 6-2).

Table 6-2

Price	Volume	Open Interest	Market
Rising	Up	Up	Strong
Rising	Down	Down	Weak
Declining	Up	Up	Weak
Declining	Down	Down	Strong

As you can see, in general, when open interest and volume are rising, they confirm the current trend. When open interest and volume are declining, they reflect that the trend is near an end.

We should note that volume and open interest are released by the exchanges with a one-day delay. Although it is possible to get estimates, the official volume and open interest numbers are not released until the day after the day after the close of trading. (For example, Monday's numbers will not be available until Wednesday morning.) Additionally, you should be aware that there are many more intricacies involved with using volume and open interest (or any other indicator, in fact) than we can cover in this book.

Commitment of Traders

The *Commitment of Traders* (COT) report is released two times per month by the CFTC. The report breaks down open-interest numbers into three categories: hedgers, large speculators, and small speculators. Hedgers and large speculators are required by law to report their positions to the CFTC. The size of a position that is deemed to be reportable varies per contract and exchange. The numbers are compiled by the CFTC to get an idea of the open interest of the larger traders. All remaining open positions in the market are assumed to be small traders.

The premise behind the COT report is that the large hedgers are usually correct about the market. They are involved in the cash trade of the business; they know how many acres have been planted; they know what the yields are anticipated to be; they know what the export market looks like; and they know what prices are likely to occur down the road. Consequently, hedgers are perceived as the "smart money."

On the other hand, small speculators are perceived to be less informed about market conditions, have limited capital, and do not have the trading skills that a professional might have. In general, people presume that the small trader is the last to know and is generally wrong about the market. Our conclusion: Follow the smart money, and avoid doing what the less-successful traders are doing.

How to Read COT Data

As a trader, you should monitor the percentage of open interest that is due to long positions and short positions. The CFTC breaks the data into the following categories: Hedger, Large Speculator, and Small Speculator.

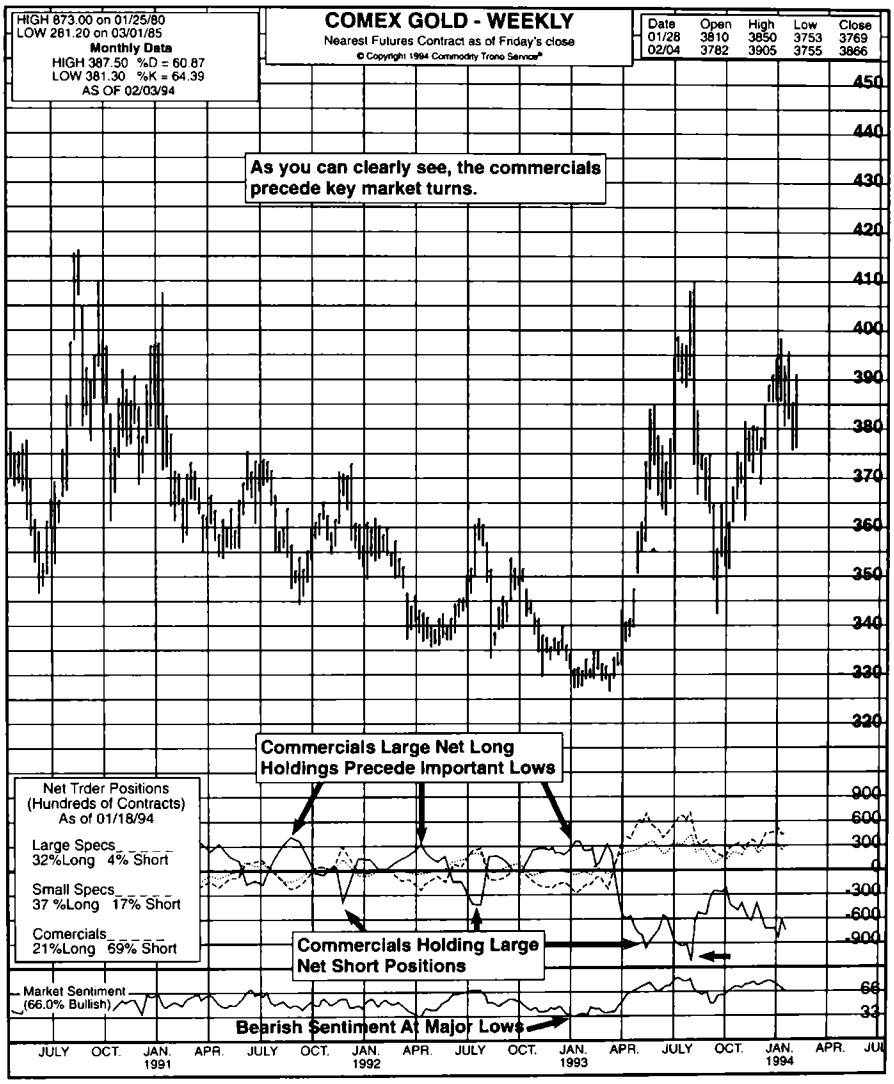
You can obtain COT data directly from the CFTC's Web site at `www.CFTC.gov`. There are also many services that provide a clear description of the data in both tabular and graphical form.

Commodity Trend Service is another recommended provider (`www.Tradeworld2000.com`). The advantage of monitoring the data in graphical form is that you can monitor where the net positions are relative to where they have been in the past. That way, you can judge whether or not the net positions are at an extreme (see Figure 6-21).

Figure 6-21 displays a snapshot of a Bloomberg terminal and lists the reportable positions for the 10-year Treasury Note futures as of March 21, 2000. You want to focus on the commercial positions listed in the middle column—the row titled "Percent of Open Interest for Each Category of Traders." Note that the Commercial Long is 68.5 percent, and the Commercial Short is 78.5 percent. The net position, therefore, is (68.5 − 78.5 = − 10.5). The net commercial position for the 10-year Treasury Notes is 10.5 percent short.

Now, look at the Non-Reportable Positions. This column represents the small traders. The percentage of open interest that is long is 13.1, while the percentage of open interest that is short is 11.6. The net position is 13.1 − 11.6 = 1.5. The small speculators are 1.5 percent short.

Figure 6-21 *CFTC*



When these numbers are at extremes (relative to the norm for that market), you should take a position. For example, if soybeans have been rallying into the growing season on prospects of a drought, and you notice that the commercials are slowly becoming short while the small speculators (the last to know) are slowly getting long, you will know to expect a turnaround soon.

COT data are not absolute (nor is any other technical trading method, for that matter)—but it does provide a good guideline when combined with other trading methods.

Troughs in a chart line, or reaction lows, indicate price support. Support is defined as the level at which buying interest is sufficiently strong to overcome selling pressure. When this situation occurs, the

decline is usually halted—and prices turn back up again. If the support line is crossed, the trend has likely changed.

Peaks in a chart line indicate resistance. Resistance is defined as the point where selling pressure overcomes buying pressure. Prices usually retreat from a resistance level. If prices break through a resistance line, the trend is likely changing.

According to Murphy, "In an uptrend, the traders who hold long positions are eagerly awaiting a pull back to add more longs. The short position holders are hoping for a pull back to exit their trades. Any traders not yet in the market are also awaiting a pull back to enter a long position.

"So you can see how with all of these soon to be buyers, the demand immediately picks up on a trade near support. The opposite is true in a downtrending market, with the participants looking to sell contracts."

One of the most important concepts to know about technical analysis is how to evaluate a market at different time periods. Although you might monitor daily price bars, there is often a longer and much more predominant trend occurring. For example, in the intermediate term, a market might be heading down—but in the longer term, it might be heading higher. Consider the stock market throughout the 1990s. Although it was plagued with many steep corrections, the overall trend was certainly higher. This situation did not mean that there were no opportunities on the short side; in fact, many traders were able to make money playing it that way. The intermediate downturns were simply part of what helped the market go higher. Markets are driven by supply and demand. With the stock market of the 1990s, stock prices fell, but because they were perceived as valuable, demand increased as they became cheaper. This situation would again catapult the market to new highs.

You should note that although markets trend, they do not move in straight lines. They move in a series of peaks and troughs, or zigzags.

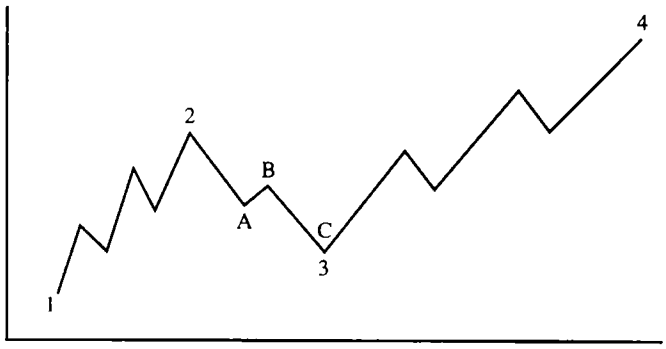
Murphy said it best when he said, "The concept of trend is absolutely essential to the technical approach of market analysis. All of the tools used by the chartist—support and resistance levels, price patterns, moving averages, trendlines, etc.—have the sole purpose of catching that trend. Marketsgenerally do not move in a straight line in one direction. Market moves are characterized by a series of zigzags. These zigzags resemble a series of successive waves with fairly obvious peaks and troughs. It is the direction of these peaks and troughs that constitutes a market trend."

If you are paying attention to the overall trend of the market, will you be able to take a step back and identify when a market is simply fulfilling one of its zigs or actually correcting? See Figure 6-22.

As you can see in Figure 6-22, which can represent any market you choose, the predominant trend is higher from left to right (points 1 to 4). You also see that there is an intermediate trend lower from left to right (points 2 to 3). Within the intermediate trend, there is also a short-term trend higher from points A to B. All markets behave in this manner when they trend, regardless of the time period in which you are trading.

What do I mean by "regardless of the time period in which you are trading?" Recall the different types of investors who trade commodities. There are hedgers, large speculators, small traders, and floor traders.

Figure 6-22 *Short Term, Long Term, and Intermediate Term trends*



Each one of these individuals has a different time horizon. Hedgers are likely to place a position, long or short, based on their capital needs. They are likely to hold these positions for a period of months or maybe years.

Large speculators are likely to be trend followers. Due to the larger size of their positions, they are not likely to be day traders; rather, they follow a trend of a more intermediate length. Although they could very well stay with a position for much longer, they might be following the market on a weekly or monthly basis.

The smaller trader tends to focus on the shorter term. Psychologically, due to their inexperience and/or limited capital, smaller traders are not likely to hold a position for more than a couple of weeks. The psychology of trading has many planes. In general, it is harder emotionally to let your winners run than it is to cut your losses short, because humans have an internal need for gratification. We all want to be rewarded for a job well done, and what better way to reward yourself than to take a profit? Statistically, if you make a habit of taking smaller profits and taking as large or even larger losses, you are bound to be a net loser in the markets.

The other side of the coin is limiting your losses. Some traders refuse to take a loss for fear that trading losses represent failure, when in general, it takes many small losses in life to succeed at any great task. For example, you might have economic setbacks to getting a college education, or you might make a sideways career move for the benefit of future opportunity. You might make several attempts at launching a new business before you are financially successful . . . heck, how many times did you try to ride a bike before you finally succeeded? Trading is no different. Trading is peppered with the peaks and valleys of winners and losers. All that really matters is the score at the end of the game.

Some small traders are day traders. They might hold a position for as little as 10 minutes. There are actually many people who are successful day traders, some of whom actually trade professionally. Then, there are floor traders who have the smallest time horizon of all. The floor trader is not necessarily interested in the trend of the market; instead, his or her goal is to buy or sell a large lot of contracts in the hopes of making a tick or two from the market.

With all of these different participants and all of the different time horizons, it stands to reason that the psychological pressures are different at different times, as well. When a transaction occurs between a buyer and a seller, they are each trading for their own reasons. A large speculator could be initiating a long position to hold for the summer, and the seller of those contracts could be a floor trader hoping to capture a short-term gain. While the large speculator will hold the longs for months, the scalper will likely exit the position (buy back the shorts) within a matter of minutes. So, although the large speculator might have a belief that the market might rise and the scalper has a belief that the market might fall, they have these opinions on different time horizons.

The existence of buyers and sellers and their corresponding opinions is what makes a market. If you combine the concept that all traders trade on different time horizons with the concept that market psychology is what drives support and resistance levels, then you are truly beginning to understand the interlocking elements that move the markets.

Let's return to the simple chart patterns that Murphy called zigzags. The success of trading lies in the ability to spot a trend and ride the trend until it ends. As we mentioned, markets do not move in straight lines (see Figures 6-23 through 6-25).

Let's use the simple technical pattern of the trendline: When a market is rising, it does so in peaks and troughs. A trendline is drawn under two successfully higher lows. The third test of the trendline confirms the upward trend (see Figure 6-26).

When a market is trending lower, a trendline is drawn above successfully lower rally highs. The third test of the trendline confirms the downtrend (see Figure 6-27).

As a market is trending, more buyers come in on the dips, and more sellers come in on the rallies. These buyers could either be initiating long positions or exiting short positions. They could be floor traders, small speculators, or long-term hedgers. The sellers are either liquidating longs

Figure 6-23 *Uptrend*

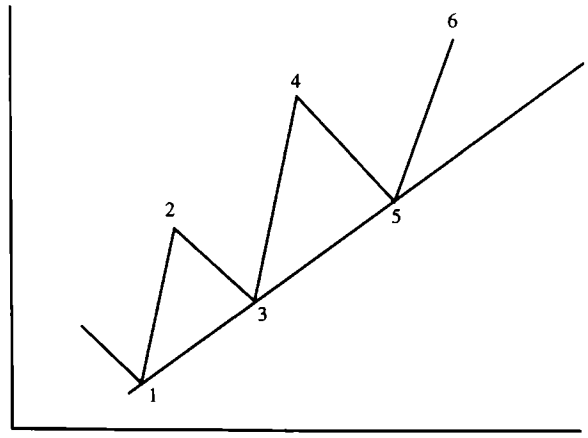


Figure 6-24 *Downtrend*

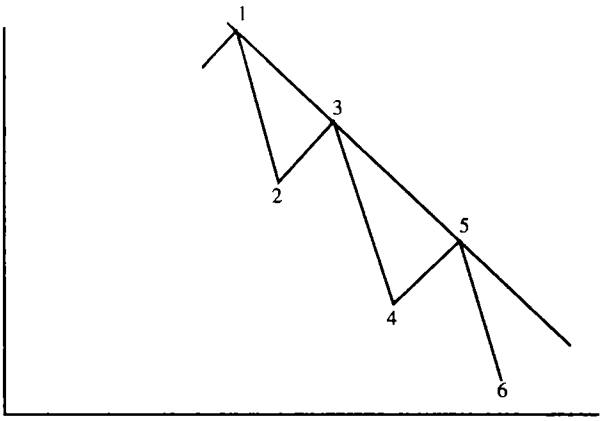


Figure 6-25 *Sideways trend*

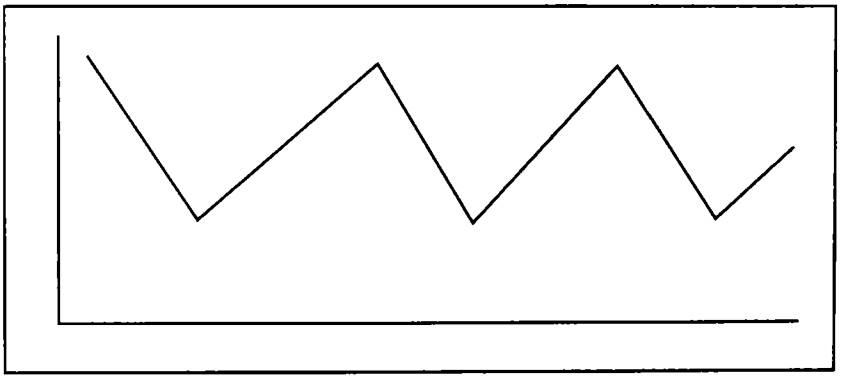


Figure 6-26 *Uptrendline*

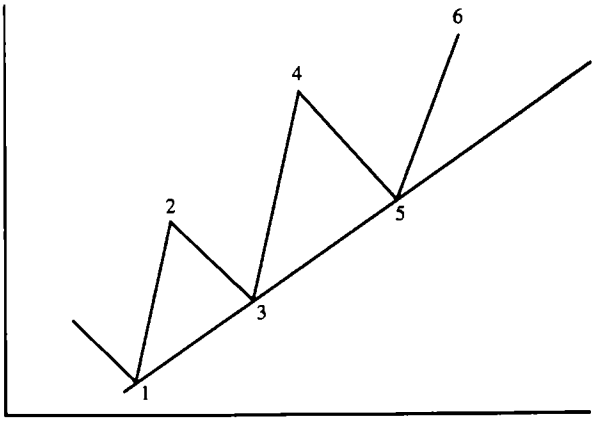


Figure 6-27 *Downtrend line*

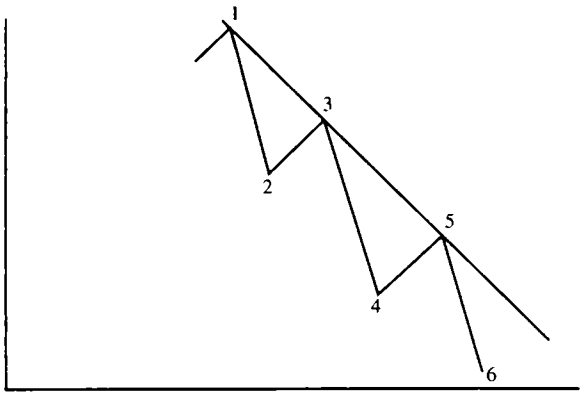
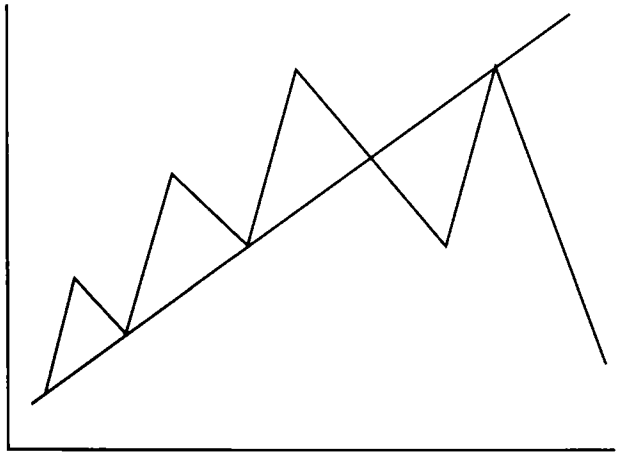


Figure 6-28 *Uptrend broken and tested*



or initiating new shorts, and again, they could be small traders, scalpers, hedgers, and so on.

Trendlines serve as support and resistance. When they are broken, they reverse roles. What was support becomes resistance, and what was resistance now becomes support (see Figures 6-28 and 6-29).

Let's now look at how trendline patterns combine on shorter- and longer-term horizons (see Figure 6-30).

There are longer-term trends and shorter-term trends. Note that the longer-term trend in our example is higher. Along the way, there are multiple trends that are also higher. These trends are broken and ultimately test the longer-term trendline. Looking at trendline #1, we see that it represents the dominant trend. This trend could extend over a matter of weeks or even months. The shorter-term trends could represent days or

Figure 6-29 *Downtrend broken and tested*

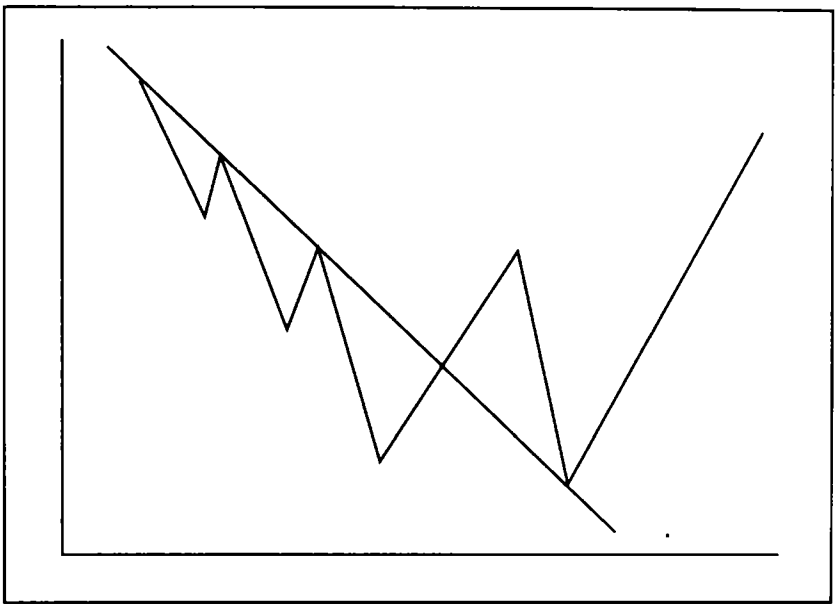
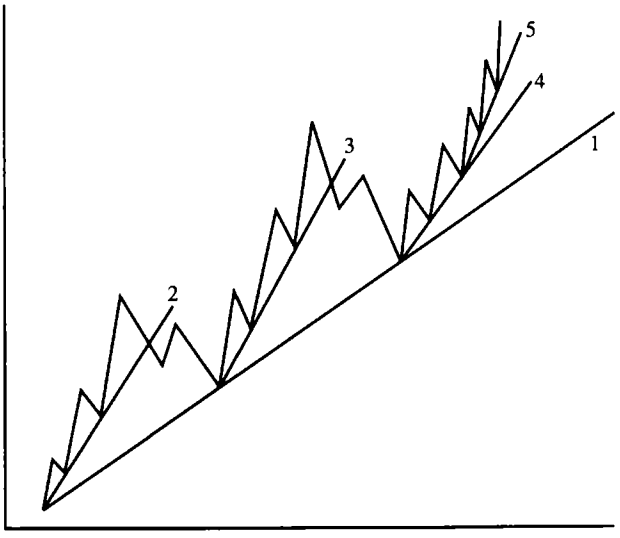


Figure 6-30 *Multiple trendlines*



even hours. Trendline 2 captures the first upleg of the trend. Trendline 2 is subsequently broken. If you were long based on the time period that represents trendline 2, you would likely liquidate your position. As you can see, trendline 2 is broken, retested, and then pulls back to create the first point of trendline 1. Also important to note is that if you were trad-

ing the market based on the time period set by trendline 2, you might not only liquidate your position—but you might also consider going short based on the retest of the uptrend. If trendline 2 represented days of the week, the market would be pulling back from its trend for at least two days. If you were a shorter-term trader, these days would be a significant time period for you. As you can see, after breaking its trend, the market soon runs into trendline 1, which is the more powerful and longer term trendline. The uptrend resumes. The uptrend resumes on a daily basis with trendline 3. The market continues on trendline 3 until it is also broken and then retested. The market again pulls back to the longer-term trendline. As you can see from trendlines 4 and 5, the market move higher has now begun to accelerate into a steeper pattern and into an even shorter time period.

The most important point that we can draw from this example is that there are counter-trend moves within the longer-term horizon. The greatest power of a trend belongs to that of the longer term. As a market moves higher, there are multitudes of different trends up and down. The shorter-term trader is interested in the different trends that occur during the day, from open to close. The intermediate-term trader is concerned with the trend that occurs throughout the week, Monday to Friday. The longer-term trader might be concerned with the trend throughout the month, from week one to week four. Regardless of the time period in which you are trading, you must always pay attention to both the shorter- and longer-term trading trends and patterns to help time your entry and exit from a position.

Now, let's have a closer look at the formation of a price bar and how it can be used to our advantage in our trading. When building the price bar, you should note that a market needs to post an open, a high, a low, and a close (see Figure 6-31).

A price bar can represent a day, a week, a month, or as little as five minutes. The sequence in which these price bars are developed can tell us a lot about the market trend. If the price bar represents a week, let's look

Figure 6-31 *Price bar*

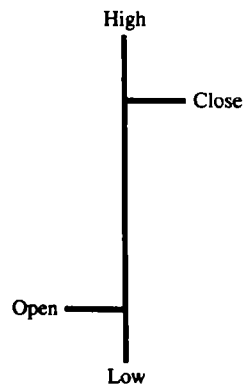
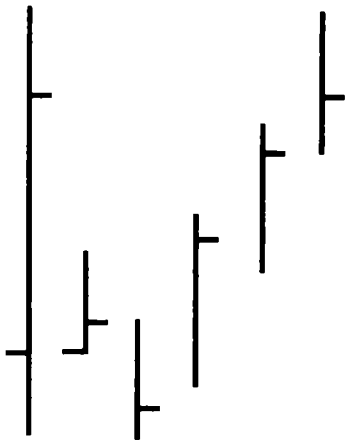


Figure 6-32 *Week price bar up*



at what might happen day to day in order to create this price bar (see Figure 6-32).

If the bar on the left represents a week of higher prices, note the pattern of Monday through Friday. To create the low end of the price bar, the market must trade lower at some time during the week. Usually, if the market is trading higher, it will first pull back to create the lows and then head higher to post a higher close. Monday might be a lower day. Tuesday might also be a lower day, but eventually the lows will turn around as prices weaken enough to test longer-term support and ultimately draw in new buyers. As the week progresses, the prices move subsequently higher.

A similar situation is also true for a market that is moving lower. If prices are generally weaker for the week, the trend might be for prices to move higher on Monday and Tuesday and then move lower throughout the rest of the week (see Figure 6-33).

Now, let's look at a longer-term scenario: the creation of a monthly price bar. If the price trend is higher for the month, where the market ends the month with higher prices than when it began, the market might be likely to post lower prices early and then strengthen as the weeks progress (see Figure 6-34).

Note that the first week of the month is down, as well as the second. In order to create the two lower weeks, where prices finish the week lower than where they began, the prices must first move higher on a daily basis and then ultimately head lower. Note how the first few days of each week are higher and then head lower to finish a lower week. As the weeks progress, the power of the monthly trend higher becomes the dominant force—and as prices test the longer-term support, they begin to rebound. Note the reaction on the daily bars as the market hits the low of the monthly bar. They first head lower, then have a sharp reaction to the lower levels as demand strengthens on those lows. Then, the pattern reverses to higher on the weekly basis (see Figure 6-35).

Figure 6-33 *Week price bar down*

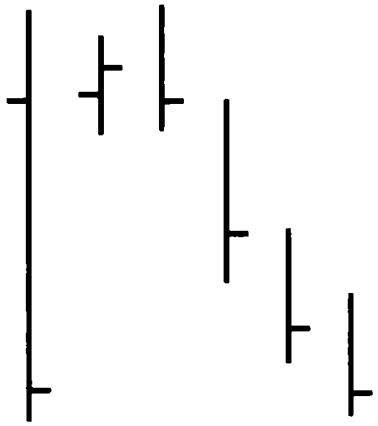


Figure 6-34 *Monthly price bar up*

Again, the same concept applies to a market that is moving down on a monthly basis, where prices are finishing the month lower than where they began. In order for this price action to occur, the market might first fill in the high end of the monthly bar by trading higher the first few weeks of the month and then heading lower. The driving force that will force prices lower will be the reaction to the resistance band of the longer term.

Of course, it is always possible for a market to ignore a rhythmic pattern. Sometimes, market scenarios are so bullish or bearish that a market barely pauses at all. Sometimes a market is exceptionally quiet, and there is no discernable trend. If you are savvy enough to wait for a developing trend, the odds are high that you will be better able to stick with it if you understand the general motions of the market.

Figure 6-35 *Monthly price bar down*

As you might imagine, this concept applies to *all* methods of technical analysis, not just trendlines (if you analyze the market response to moving averages, stochastics, and so on).

Chapter 7

Tips of the Trade

Introduction
Exchange for Physical (EFP)
Federal Fund Futures: Predicting Interest-Rate Changes
How to Correct an Error

Introduction

Trading leaves a long trail of hard knocks. Many times, traders' mistakes are due to a lack of experience, and other times, the mistakes are due to a lack of knowledge. The difference between the two is that you can gain knowledge through research, but you can gain experience only over time. Few publications teach the practical side of trading. Some teach analysis or order entry, but most do not provide insight into how a market trades or what type of price action to which the trading pit is prone.

What follows is a list of each major commodity item. Included are important things to know about how the particular market trades. Keep in mind, however, that as with any reference tool, things change. Much of what is listed here is based on opinion, and opinions vary between individuals. Opinions are also subject to change over time. Always double check current rules and contract specifications before placing any trades.

Corn

This market is a relatively small contract. Each penny move is worth $50. Corn does not tend to whip around like some of the other grain products. The margin requirement is usually around $500, so corn is a product that is comfortable to trade for most accounts. Corn is a great trend-following product; thus, you can participate in long-term positions. This product is not without its riskier moments, however. In a drought situation, corn might lock limit up for a few days in a row.

Always remember that the corn futures contract trades in one-fourth cent increments, and the options trade in one-eighth cent increments. When you see futures prices on your screen, the prices might be quoted as 2406, which translates into 240 3/4 cents or $2.40 3/4 per bushel. The six is how many eighths there are in the fractions (6/8 = 3/4). The options will look as follows: 240c 162, which translates into 16 1/4 cents. The two is 2/8, or 1/4. If the quote were 161, it would be 16 1/8.

Wheat

Unlike corn, wheat is one of the wilder grain products. The daily moves tend to be greater than corn. The market is thinner than the other grain products; thus, the prices can be more erratic. The wheat market saw its most memorable times during the great bull run of 1995–1996. The price of wheat hit a historic $6.50 per bushel. The United States was experiencing a drought in the wheat-growing region that was beyond comparison. The supply of wheat was dismal. As with any bull market, eventually higher prices are a cure for higher prices. Once wheat hit a breaking point of extreme price levels, the demand dropped off, imports increased, and the price of wheat fell. If we can learn anything from this move in wheat, it is to always remember the short side of grains as well. Too many traders made multiple returns on their investment but gave it all away, refusing to believe that the price of wheat could ever come down.

Always remember to protect your profits by placing stops and being flexible. Learn to recognize when a trend has changed, and do not stay in a position for too long.

Soybeans

Probably one of the most glamorous commodities is the soybean market. Everyone wants to participate in great bull moves. As with wheat, never forget the short side. Commodity markets trend lower as well as higher; however, this fact does not mean that you want to sell into a big drought scare. You could get clobbered. Soybeans have been known to lock limit up for days in extreme conditions, so be careful.

Any market that has a history of explosive moves is prone to being exploited in advertising. How many times have you seen advertising from chop shops telling you that this year will be the year of the next soybean run? The advertisements say things such as, "Take $5,000 in to $20,000 in two weeks!", and they are successful in luring get-rich-quick fanatics.

The result is that there are many firms peddling out-of-the-money options. These options are cheap, and consequently, the client can buy more of them and bring in bigger commission dollars to the broker. Buying a lot of inexpensive options gives the trader a chance (although a small one) at making leveraged returns. This influx of speculator buying bids up the price of these out-of-the-money options until they are extremely overvalued. Most floor traders are glad to sell these expensive options to the novice buyer. More often than not, these options expire and are worthless.

A way to identify this type of extreme is by running a skew analysis. Most data providers will include option-volatility information. Do not get caught buying overvalued options.

Soybean Meal. Soybean meal is a product of soybeans. Soybeans are crushed into meal and oil. The primary use of soybean meal is to feed chickens. Soybean meal is a thinner market but a trend follower nonetheless. Unlike the other grain products, soybean meal trades in dimes and is not quoted by the bushel, but rather by weight. When reading the prices on a screen, remember that soybean meal is quoted in dollars per ton.

Soybean Oil. Soybean oil is a product of soybeans. This product is primarily used in bakery products. Competitors or substitutes for soybean oil are palm oil or other vegetable oils. Due to its relative illiquidity, however, soybean oil has some erratic movements. Unlike most grain contracts, soybean oil is quoted in cents per pound.

Gold

Have you heard of the "gold bug?" That term is used to describe the constant desire to be long gold. From 1992 until the end of 1999, we saw the largest economic expansion in history. The stock market was on fire; the dollar was strong; and inflation was nowhere to be found. All of these

factors are bearish for the gold market. Gold had a few significant rallies during that period, but in general, the trend was strictly down. The gold bugs however, were constantly buzzing. Gold bugs remember 1976 through the end of 1980, when gold moved from 100 dollars per ounce to a peak at nearly $700 per ounce. A lot of people made a lot of money during that period. We can bet that in 1981, when gold fell from more than $650 to $300, there was a lot of speculator money lost when buying call options in preparation for the next move higher. In fact, there is still a lot of speculator money lost to gold options, so stay with the trend and forget the speculative hoping for the next $1 million move.

Silver

Silver is also a product that was depressed in price throughout the 1990s. We had a few good runs, but most people are still buying silver in the hopes that the Hunt Brothers will come out of retirement and make their next million for them. You might remember the Hunt Brothers as a couple of traders who attempted to corner the silver market. Before they were forced out of their positions and into bankruptcy, silver ran from $5 per ounce to $35 per ounce. Since that time, silver has been on both sides of $5 but never much higher or lower.

In a bull market environment, there is no need to rush to the safe haven of precious metals. We do not mean that the metal markets will never go up again; rather, in the late 1990s, they "lost their luster."

Copper

Copper is an industrial metal and a larger and more volatile contract than gold or silver. Copper is influenced by reports on the housing sector and overseas trade. In a strong housing market, demand for copper is also strong. Copper is not as widely traded by speculators but can be a good trend-following vehicle.

S&P 500

Throughout their professional careers, many people have made it their personal goal to master the movement S&P 500 contract. Of course, using the word *master* is probably too strong. We find it hard to imagine that there is one trader alive who can honestly say that he or she has mastered anything. The secret of success of trading is to simply have your successes outweigh your failures, not to expect perfection.

The S&P 500 is a large contract with incredible price swings. You can make a tremendous amount of money trading the S&P, and consequently, the market attracts some of the best traders in the business.

If you are trading the S&P 500 Index, particularly as a day trader, you need to consider the competition. Floor traders earn their living by pushing the market to extremes in one direction or another. This situation might mean that as you enter a market order, you might not get the fill that you desire. Your screen might be telling you that the last trade is

1380.50, but as you are picking up the phone and entering an order to buy, you will see it jump higher and higher as you listen to the floor activity. Your fill could come back at 1382.50, which is two full points higher (or $500 more than when you picked up the phone). The market might then immediately fall back to the level it was originally. This situation puts you $500 behind immediately and makes the trade psychologically more difficult to monitor.

If you are monitoring the price action on a minute-by-minute basis, you will continue to witness fills at the high end of the price bar if you are buying and on the low end of the price bar if you are selling (that is, until you begin to understand the sport). Trading, as they say, is a zero-sum game, and the floor traders are trying to take your money. Until you have a considerable amount of experience, the odds are that they will win.

Regardless of the amount of risk capital that you have, consider trading the mini-S&P contract until you gain enough experience to justify taking the risk.

Mini-S&P 500

Far and wide, the mini-S&P 500 is the best contract for short-term speculators ever developed. The E-mini trades on the GLOBEX system of the *Chicago Mercantile Exchange* (CME) and follows the big S&P futures contract but is one-fifth the size. In other words, each full-point move is worth $50. The margin requirement is as little as $2500, and the average speculator can make a reasonable attempt at trading it with as little as $10,000 in the account. That $10,000 allows room for mistakes throughout the education process, without crunching the pocketbook (provided, of course, that you do not over-trade or take exorbitant risks).

The E-mini is strictly electronic and trades 24 hours Sunday through Friday. Outside of size, the other difference is that the E-mini trades in ¼-point or .25 increments, as opposed to the .10 increment of the big S&P. For this reason, the mini might be trading at a slightly different price than the larger contract. Another reason is the liquidity. Although the volume in the E-mini is more than adequate, it is lower than the big S&P and thus has swings that are slightly wider on occasion.

The disparity in minimum price fluctuation provides fantastic arbitrage opportunity for floor traders, which is one of the reasons for the contract's tremendous success. Floor traders can currently trade E-mini contracts via open outcry if they trade in blocks of 25 or higher. Twenty-five contracts are the equivalent of five of the larger S&P contract. If there is enough disparity between the two contracts during the day, a trader can sell 25 E-minis against a buy of five S&P contracts and effectively lock in a profit of the difference.

Some firms will accept stop orders on the E-mini, which to date has not been available on most electronic contracts. You cannot place a *One Order Cancels the Other* (OCO) order electronically, however. The trader or a personal broker must monitor the stop and limit orders.

The E-mini is a great vehicle through which to practice day trading. If you trade too often, you might find that commissions eat up most of

your profits, because the gains are of a smaller size. The plus side, however, is that your losses will be considerably less.

Another advantage of the E-mini is that it is one of the best contracts to be traded via the Internet. Many firms offer online trading, but for day traders, this feature does not always afford a tremendous advantage (depends on the firm and the system). But because the E-mini is electronically traded, there is a significant time savings by being able to access the terminal directly via the Internet.

NASDAQ 100 and Mini NASDAQ 100

The NASDAQ 100 is an index that tracks the weighted performance of the top 100 NASDAQ stocks. The futures contract itself is relatively thinly traded. When a contract has limited participation and low trading volume, it becomes difficult to trade. Although the NASDAQ 100 might be a good trend-following tool for larger accounts, it currently is not a good vehicle for day traders due to the illiquidity and wide bid/offer spread.

The mini-NASDAQ is a smaller version of the NASDAQ 100 futures contract—exactly one-fifth its size. The mini-NASDAQ is traded electronically on Globex, just like the E-mini. For most accounts, the mini-NASDAQ is an outstanding contract to trade. Although the liquidity is not quite to the level of the E-mini S&P, the affordability of the contract makes it a viable investment vehicle for most traders.

Consider the NASDAQ decline of the early part of 2000, when Microsoft was struggling with its antitrust suit. If you owned a large portfolio of NASDAQ composite stocks, the E-NASDAQ would have served as a tremendous hedging instrument. There would have been many dollars made being short the index, with little risk exposure. For this reason, the futures contracts were designed to hedge against price exposure.

Dow Jones Industrial Average

The Dow Jones Industrial Average is another one of the best contracts available. The Dow Jones Industrial Average is a smaller contract that is traded via open outcry at the *Chicago Board of Trade* (CBOT). (At this writing, the CBOT had introduced a side-by-side electronic Dow contract to test the success of trading electronically.) Each point move is worth $10, so each 100-point move in the Dow is the equivalent of $1,000.

The most noteworthy aspect of the Dow is that it is a combination of a speculator contract that is heavily influenced by the traders in the pit. The locals made their money by taking it from the smaller speculators. Here is how this task was performed:

The Dow Jones futures contract opens the outcry session at 7:20 A.M. Central time. The Dow Jones Industrial Average Index (stock prices) does not open until 8:30 A.M. Central time. If the news was particularly bearish in overseas trading, the Dow futures would open down about 50 points and trade lower. The cash market often opens closer to the price of the day before and then advances downward. Just as the cash market would open, the futures would rise to meet the level and then return to the

downside. What would happen to all of the speculators who sold futures contracts at the 7:20 A.M. open? They would be stopped out. Most every small speculator who decides to trade risks some amount. He or she might place a $250, $500, or even $1,000 stop. The floor traders know this situation. Thus, they push the market higher in an attempt to trigger those stops. If the small trader is short, then he or she might have an order to buy back the short if the market trades $500 points higher. The Dow moves 50 points higher than the open, and the speculator is stopped out. The locals are the ones who sell the contracts to the speculators. The trend for the day is clearly down, but counter-trend gyrations take the smaller trader out of the market.

You can see this behavior again and again. If you follow a market long enough, this type of pattern becomes predictable. As you gain experience trading, you will learn to wait for the counter-trend moves and not be sucked in on the open or at the highs and lows.

The behavior of the average speculator is predictable. Floor traders count on the paper flow of orders to come in at the designated time each and every day. Learn to be smarter than they are. Do not be blindly predictable.

Japanese Yen

The currency futures markets were at one time one of the best vehicles for profit. In the early 1990s, the currencies had fantastic intra-day swings that enabled great trading opportunities. As the Forex and EFP markets began to gain in size, the daily volume in futures began to decline—and the day-trading profit opportunities began to fade.

There were times that the Japanese yen would open 600 points higher or lower from the previous day ($7,500 dollars per contract). Never underestimate the currency markets and the types of moves that they can make.

The currencies were volatile during the early 1990s because they were more sensitive to interest rates, money supply, and the reading on the U. S. Trade Balance reports. As the economy underwent this tremendous expansion, this volatility subsided. The U. S. dollar became the most solid and stable currency on the globe. There will be a time again when the dollar fluctuates and falls in and out of favor. The currency markets will again return as a fantastic day-trading vehicle.

Euro Currency

The Euro is a relatively new introduction into the currency arena. The Euro is a composite of 11 European currencies. The British pound and Swiss franc are not part of the Euro, which might partly explain why it has struggled since its inception. Throughout 1999, the Euro headed steadily lower versus the dollar. Analysts cited several reasons—one due to the fact that the United States grew much faster than the 11 other nations, and two, the fact that managing a united, single currency is more difficult than previously imagined.

When the United States experiences strong growth coupled with a strong stock market, the incentive exists for foreign money to be invested in U. S. dollar-denominated products (such as stocks and U. S. treasuries). In order to buy dollar denominated assets, investors must first convert their own currency into U. S. dollars. To do that, they must sell Euros to buy dollars. Thus, the move is higher in dollar, lower in Euro. As long as the perception of opportunity is greater in the United States, the trend is likely to continue as such.

What happens if growth in the United States begins to slow? What if the perception changes? If investors feel that the opportunity for profit has shifted back to Europe (their economy recovers and expands), then money will no longer pour into the U. S. market. In fact, money might leave the U. S. market. If investors sell their assets, stock prices will fall. When they convert the money back into Euros, they sell dollars to buy Euros—and the dollar weakens.

This situation is a large part of what led to the Crash of 1987. Stocks were at lofty levels, and foreign investors began to sell. As the dollar began to lose value, foreign investors began to lose confidence in the U. S. stock market and in any other investment that was denominated in U. S. dollars. The result was a snowball effect that led to the precipitous selling of U. S. stocks and ultimately, the crash.

Exchange for Physical (EFP)

The EFP market is an important consideration in the currency arena. This market is one in which you can place stop orders in overnight trading. (Most contracts trade electronically overnight on the Globex or Project A sessions. At the time of this writing, stop orders were not accepted.)

Stops can be placed because one contract on the EFP offsets one contract on the futures exchange, and the EFP market is 24 hours. At first glance, this feature appears to be useful, but there are some risks associated with placing a stop order on the EFP. The primary reason is because the market conditions are thin, and your trade might be stopped out unnecessarily. Market action in the EFP might not parallel the action of the futures contracts; thus, support and resistance calculations might not apply.

When placing a stop, you have three choices: stop-bid, stop-middle, and stop-offer. A stop-bid means that your stop is executed if there is a bid at your price level. A stop-middle means that your stop is executed if the bid offer surrounds your price. A stop-offer means that your stop is executed if there is an offer at your price level.

There does not need to be a trade at your price as with futures; merely a bid or offer. Thus, it is possible that you can get stopped out unnecessarily.

If you or a client are in a trade where overnight action might be too risky for your position, consider exiting the trade or using the Mid-Am contracts instead.

Swiss Franc

An important thing to remember about the Swiss franc is that if the U. S. stock market is down, the Swiss franc is usually up. Apparently, money tends to move into the Swiss franc when things get tough for the equity market. Perhaps it has something to do with the fact that Swiss banks are required to keep a percentage of gold on hand or the way in which Swiss bank accounts are structured to maintain anonymity. Regardless, it seems as though the Swiss franc is the "flight to quality" currency.

Dollar Index

The dollar index tracks the performance of the dollar against several different currencies and is an *index*, not a currency. Therefore, the dollar index does not trade on the EFP. The dollar index trades virtually 24 hours, however, on *Financial Instruments Exchange* (Finex) in New York.

The dollar index has the following weightings (see Table 7-1).

Table 7-1

Currency	Percentage
Deutsche mark	20.8
Yen*	13.6
French franc	13.1
British pound*	11.9
Canadian dollar*	9.1
Italian lira	9.0
Netherlands guilder	8.3
Belgian franc	6.4
Swedish krona*	4.2
Swiss franc*	3.6

*Now all in EuroCurrency so 57.6% Euro weighted in Dollar Index

Many traders would argue that this weighting is outdated, meaning that it does not accurately represent the strength of other economies. For example, the only Asian currency that is represented is the Japanese yen. Some traders say that the dollar index is too heavily weighted toward Europe. Perhaps this index will change eventually.

30-Year T-Bonds

Treasury bonds (T-bonds) were, at one time, the most actively traded futures contract in the world. Many millionaires originated in the T-bond pit, and many ended up broken.

The contract first began trading in 1977. During that period, the U. S. government debt was growing considerably, and the interest-rate environment was volatile. This contract attracted many investors from across the globe who utilized this vehicle to hedge against their interest-rate exposure as a result of owning U. S. government debts. Trading in this futures contract enabled investors to lock in long-term lending or financing rates and protect their portfolios from interest-rate fluctuations.

The volume of hedgers in this contract also attracted a broad-based group of speculators, who again added to the tremendous liquidity of this contract.

When trading bond futures, you must pay attention to the cash market. The cash market trades virtually 24 hours and can offer some insight as to how the day's trade might develop. Due to the liquidity of the bond market, cash prices are easy to find.

During the first part of 2000, the treasury department announced that it would be buying back outstanding long-term debt. The extent of the buyback plan focused on bonds that had more than 15 years to maturity. They also announced that they would begin to taper back the amount of long-term debt that they would issue in the future. The reason, the Treasury noted, was because the government was awash with cash at the time and did not need to maintain as much long-term debt to finance daily activities. The economy was doing extremely well.

With the treasury buying back debt and the perception of dwindling supply, the 30-year T-bonds surged in price. Although the Federal Reserve was in a tightening mode at the time (raising interest rates), the 30-year Treasury yields continued to fall. The trade in the T-bond pit was less focused on the economic conditions and more focused on the supply picture. Because yields on the 30-year T-bonds were falling faster than the yields on shorter-dated maturities, the traditional yield curve began to invert (see Figure 7-1).

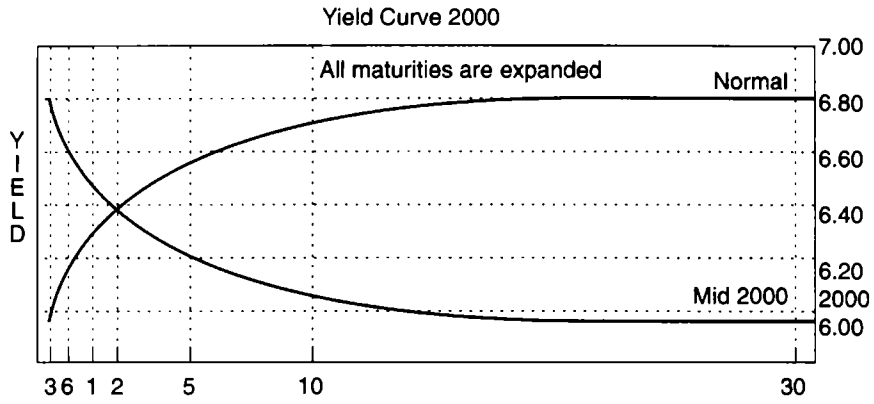
Usually, long-term yields are higher than short-term yields in order to compensate for the risk of tying up your money for a longer period. In the early part of 2000, the opposite was true.

In most occurrences, the yield curve reveals what the market expects to happen to interest rates in the near term, as well as in the future. Previously, when the yield curve was inverted, the expectation was for higher rates in the near term and an economic slowdown (recession) in the future. An inverted yield curve also has preceded equity market corrections.

In the first part of 2000, the Federal Reserve was raising rates and the stock market did correct, but many analysts were unsure as to what this particular yield curve was forecasting. The confusion was due to the fact that the inversion was more a function of supply and demand than pure economic anticipation.

The speculation and uncertainty in the marketplace changed regarding how the bond market operates. Before the buyback volatility, the 30-year T-bond had been used as a benchmark against which most new debt offerings were priced. For example, a mortgage company that was to issue debt based the rate of the offering by a certain amount above where the 30-year T-bonds were trading. Because T-bonds are considered the safest investment vehicle available, the extent to which the yields of a debt offer-

Figure 7-1 *Yield curve 2000*



ing were in premium to treasury yields was based on the perceived amount of risk of the issue. The rating of the bond, the security of the issuer, and the term of the issue determined the risk.

Because the 30-year yields were distorted due to the buyback situation, there was confusion in the marketplace as to how to price incoming issues. This confusion began in order to deter investors from participating in the 30-year contract, and the volume began to decline.

The focus began to shift to the 10-year Treasury note as a more stable benchmark. This movement also attracted more business into the 10-year T-note futures pit.

10-Year T-Note

For reasons mentioned earlier, the 10-year T-note futures began to increase in popularity during the first part of 2000. At one point, in mid-April of that year, the open interest on the T-note futures exceeded that of the 30-year bond pit, and official changes had begun. The 10-year T-note was the new benchmark security.

As the T-note gained popularity, it became a better vehicle for speculators, as well. The more liquid a contract, the more viable the trading vehicle. The tick value on a T-note is one-half of 1/32nd of one percent, or more clearly, 1/64th of one percent. Each tick is worth $15.625, and there are 64 ticks in one full point. One full point is worth $1,000.

The difference between a note and a bond has to do with the length of maturity. A note is qualified as a security with maturities of one to 10 years. A bond has a maturity of 10 years or longer.

Pork Bellies: A Scale Trading Story. An extremely volatile contract due to its illiquidity, pork bellies have a tendency to lock limit more often than most. I mention pork bellies because this market had a profound impact on my development as a broker and trader.

One of my first experiences as a commodity broker was as a scale trader in the pork belly market. Apparently, there are books that advertise that you cannot lose trading commodities if you simply buy a market as it makes all-time lows and add to your position over time. The assumption is that eventually, the market will rise, and you will be extraordinarily profitable.

In this example, the trader was trying find a bottom in the pork belly market by scaling down his positions. He would buy a contract, and if it fell lower, he would buy another, then another, and then another. Before he knew it, he had 30 contracts of pork bellies in his account.

This concept might work with stocks or mutual funds, and it might even work in commodities—provided that you have enough money. Unless a company goes bankrupt, scale buying in a stock might pay off if you have enough time. Some people might buy stocks on margin, but keep in mind that margin on stocks is currently 50 percent. Margin on commodities is as low as 3 percent. Do not underestimate the amount of money that might actually be required to maintain this type of strategy.

Plus, you do not have the benefit of endless time. As a futures contract approaches expiration, you need to roll over into the next-available contract. This situation costs commissions, and the aberrations in price from one to another might impact your pricing structure.

Because commodity accounts are marked to the market at the close of each trading day, you must have adequate margin in your account to hold the position. As you continue to add positions, this margin level can grow to enormous levels. As you add positions, each move in the market against you has now increased by the number of positions that you have added.

Let's utilize an example as to how this type of strategy can become extremely expensive. The trader opened the account with $100,000. He was expecting the pork belly market to find a low over the next few weeks. The margin requirement was $1,600 per contract at the time. With $100,000, it seemed that he had plenty of money to start buying pork bellies.

He bought 10 contracts right at the start and placed open orders to buy more if the contract became cheaper. With a $100,000 account, the margin on 10 contracts was $16,000 (or only 16 percent of the account value). Let's look at Table 7-2 to see how market losses began to creep up on him.

Table 7-2

Buys	Price	Net Loss	Balance	Margin
10	66.00	0	$100,000	$16,000
5	64.00	$8,000	$92,000	$24,000
5	62.00	$20,000	$80,000	$32,000
5	60.00	$36,000	$64,000	$40,000
5	58.00	$56,000	$44,000	$48,000

At this point, the trader is on margin call. The account balance is only $44,000, and the margin requirement is $48,000. Plus, with 30 positions

in the account, that meant that for every one-cent move against the position, the loss in the account was now a hefty $12,000 ($40,000 lbs. × $.01 × 30 contracts). The trader had to wire money to keep the account in good standing. He was so insistent that the market would move higher that he wired $20,000 and did not liquidate any positions.

The situation got worse. Because pork bellies had turned surprisingly bearish, the selling began to exaggerate. That day, the market traded limit down. Even if the trader wanted to liquidate, market conditions would not enable this action. By the time that he was able to liquidate the positions, pork bellies were at 54.00. At 54 cents, the total loss on the account was $104,000. The account balance was $16,000. The trader started with $100,000, added $20,000, and was left with $16,000.

Many problems exist with this scenario. Although the account seemed to be adequately large, the amount of positions that were being added increased the risk at a rapid pace. As there were more contracts, the account balance depreciated at a more rapid pace. The relative value of the margin requirement to the account balance also rose.

This experience shows us how important it is not to utilize this type of transaction unless you have at least 50 percent of the full contract value of each contract available. Also, never allow losses to reach such an extraordinary proportion of the account size. This scenario was the result of about a 10 percent move in the contract value. Obviously, market conditions cannot be controlled, but by staying away from thinly traded markets, you might be more likely to avoid volatile conditions.

Here are the lessons that we learned:

1. Do not trade thin markets.
2. Do not over-leverage your account.
3. Do not throw good money after bad money.
4. Limit losses at all times.
5. Take a loss, and live to trade another day.

Lumber: Limit Up

The biggest market move I ever witnessed was a bull run in lumber. Similar to the scenario we described earlier, lumber taught me important lessons early in the game. In this example, a discount trader called in a panic. He was stuck in a lock-limit situation in lumber. By the time he got to us, he was losing more than $10,000 per day and could not exit.

Lumber prices had been falling dramatically at the time. The economy was weak, and the demand for lumber was slow—so slow, in fact, that many saw mills had closed down operations entirely. Then, a report on housing starts was released and showed a dramatic surge in new residential construction projects. Housing starts are a leading economic indicator and signified an economic turnaround. When the economy improves, the demand for new homes increases. In order to keep up with the pace of demand for new homes, there must be an adequate supply of lumber with which to build them. With many of the mills shut down,

there was a concern that an extreme shortage of lumber would occur in the future. Needless to say, prices surged.

Lumber was a large contract at the time—more than two times the size it is currently—and a limit move equated to about $8,000. After the early-morning report, lumber locked limit up. In fact, lumber locked limit up for 14 trading days in a row before a trade took place.

The trader had been on a golfing trip and did not know about the report. He was short one contract of lumber without a stop. (A stop could have been executed the day of the report, before the panic began to set in.) Lumber had locked limit for two days in a row before he decided to check the prices. Recognizing the potential loss that was at hand, he was scared and did not know what to do.

Fortunately for this trader, lumber has an options market, and we knew what to do with it. Because he was short one contract, an offsetting position in the options market is a synthetic long position. A synthetic long position consists of one long call and one short put, both at the same strike price. At this point, we could not recover the lost money, but we could at least put a cap on how much he would lose. The down side to the scenario was that lumber had already begun to move, and due to the thin conditions and surge in volatility, it still was not cheap to offset the risk. Plus, we did not know how long lumber would rise, and there was always the chance that we would lock in a loss that would be greater than necessary if prices receded.

We were successful, however, and were able to save him about $100,000 in potential losses—$100,000 on *one* contract of lumber.

Here are the lessons that we learned:

1. Do not trade thin markets.
2. Always use a stop.
3. Pay attention to your trades.
4. Do not get involved in something without knowing the risks.
5. Employ a full-service broker whom you can trust.
6. Brokers are not infallible, but they occasionally prove their worth.

Euro Dollars

Euro dollars are one of the most liquid contracts available and the largest futures pit in the world. Euro dollars are short-term interest-rate products. The contract represents the simple interest earned on $1 million deposited in foreign accounts for 90 days. In effect, the Euro dollar is the interest rate that the dollar commands on deposit outside the United States. You can discover the price by taking 100 minus the anticipated yield. 92.75 represents an interest rate of 7.25 percent, for example. The contract is liquid because banks utilize this contract to hedge short-term interest-rate exposure. This contract is actively traded. Open interest on the contract will be high for many months and years ahead.

Just as illiquidity adds to volatility, the fact that Euro dollars are liquid means that they typically are not volatile and can be a safe vehicle in

which to invest. The price moves inversely to rates and can be an excellent trend-following instrument.

Federal Fund Futures: Predicting Interest-Rate Changes

Federal fund futures represent one of the best vehicles for predicting interest rates. This contract follows the current federal funds rate and prices where the market expects the federal funds rate to be down the road. The federal funds rate is the interest rate charged by banks with excess reserves at a Federal Reserve district bank to banks that need overnight loans in order to meet the reserve requirement. This fund is the most sensitive indicator of the direction of interest rates, because it is set daily by the market. Banks also use this product to hedge interest-rate exposure to a lesser degree than Euro dollars.

The best tool that the federal fund futures offer is a predictor of Federal Reserve interest-rate changes. You should know how to calculate this expectation for your clients. Knowing what the market is expecting in terms of interest-rate changes is helpful for making all kinds of investment decisions. All you need is the current federal funds rate for the date of the next *Federal Open Market Committee* (FOMC) meeting and the price of the futures contract.

Let's say that the current federal funds rate is 6.00 percent, and the May futures contract is trading at 93.80. 93.80 implies an interest rate expectation of 6.20 percent (100 − 93.80 = 6.20).

The FOMC meeting is May 16, which means that if we want to find out whether the Federal Reserve will increase interest rates by 1/4 percent in May, we have to assume that there will be 16 days with a current federal funds rate of 6.00 percent and 15 days with the new rate of 6.25 percent. (Federal fund futures contracts expire on the last day of the month, and there are 31 days in May.)

Now, we take the weighted average of interest rates in May: (16 × 6.00) + (15 × 6.25) = 189.75. Then, we take 189.75 divided by 31 (the number of days in May), which equals an average rate expectation of 6.12 in May.

Because the May federal funds futures are trading at 6.20 percent, that implies that the futures are anticipating the average month of May to be even higher than 6.12 percent. This situation is the first indication that the market thinks the rate increase might be greater than 1/4 percent. (The market is usually right.)

Let's see how the probability of that occurrence has been priced into the market. Again, take the weighted average of the rate change over May, but this time use a new federal funds rate of 6.50 percent:

(16 × 6.00) + (15 × 6.50) = 193.50
193.50 divided by 31 days in May = 6.24

With May trading at 6.20 percent, this situation implies that .20 of .24 is already priced into the market. .20 is 83.33 percent of .24 (.20 divided

by .24 equals .83333). That statement implies that the market has priced in about an 83 percent chance that the Federal Reserve will raise rates by 1/2 percent when it meets on May 16.

The market arrives at this percentage based on the fundamental economic information released to date. If more inflationary news is released, the market will likely increase the expectation. If the data is tame, the market will likely decrease the anticipation. On the day of the FOMC meeting, the nearest futures will reflect the broadest estimate available as to what the Federal Reserve's decision might be. This system is not infallible, but traders tell me that it is correct about 80 percent of the time. The federal fund futures are monitored closely by economists and strategists and help with trade decisions and economic forecasting.

How to Correct an Error

As careful as we are, mistakes do happen. The most important thing to avoid when mistakes occur is making the situation worse. To avoid compounding the problem or adding insult to injury, you must follow a few very important rules. One positive aspect of making a mistake is that you can learn from it. Over seven years as a futures broker, I have probably made or seen every type of mistake. Learning how to exit an error situation is almost as important as leaning how to avoid one. First, let's discuss the types of errors that can occur—and then we will demonstrate how to avoid them.

Error Examples.

1. The client calls his or her broker and places an order to buy. The broker calls the floor and places the order as a sell.
2. The broker calls the floor and places an order to sell. The floor clerk executes a buy order.
3. The client exits the trade and forgets to cancel the stop.
4. The floor broker misses a stop or limit order.
5. An open order is placed as a day order.
6. The client calls his or her broker and cancels an open order. The broker forgets to perform this action.
7. The client places an order to buy two; the broker enters an order to buy one (or any other quantity disparity).
8. A limit order that was assumedly filled was not filled.
9. During multiple day trades, the trader loses track of his or her current position.
10. A double fill occurs.
11. Key-punch errors occur.
12. A buy-sell error occurs (a common mistake and an expensive one):

Client: "Buy one S&P at the market."
Broker repeats, "Buy one S&P at the market?"
Client: "Yes."

The broker writes the ticket as a sell order by accident but has repeated what he or she heard the client say before actually writing the ticket. The broker now calls floor, reads the ticket as a sell order, and tells the clerk to sell one at the market. The clerk repeats the sell order, the floor broker fills the sell order, and the clerk gives the fill to the broker. The broker relays the fill to the client.

Scenario 1.

Broker: "OK, you sold one S&P at 1401.50."
Client: "I sold one? I said buy."

Clearly, the broker has made the error here. He or she has written "sell" on the ticket, however, and might believe that it was the client who made the mistake. At that moment, we do not care who is right or wrong. What is important is clearing up the mistake as quickly as possible. The broker should then do two things: 1) confirm with the client that he or she wishes to sell one (important), and then 2) call the floor and place the offsetting orders.

The broker should take just enough time to confirm that the error did indeed occur. He or she needs to confirm that the client really did mean to buy before offsetting the trade. (Possibly, the client could review his or her records and realize that it should have been a sell after all. There are also times in which the client might not want to buy anymore if the market has moved down.) The broker should also take a split second to confirm with the floor that the order was indeed a sell. Once both situations are confirmed and the error is recognized a valid mistake, the broker needs to offset the trade.

To offset a sell that should have been a buy, the order is to now buy two at the market. The first order will offset the accidental sell (the broker takes the trade), and the other buy will belong to the client.

More often than not, this type of error will require the broker and his or her manager to review the tape. Most trading lines are recorded for precisely this purpose. Upon reviewing the tape, it will be clear who was at fault—and position and cash adjustments need to be made.

Because this error is the broker's responsibility, he or she must then transfer the accidental sell and the offsetting buy into the error account. Depending on the price action at the time and how long it takes to confirm the mistake, this trade could be a winner or a loser.

Each brokerage firm has an error account, and all positions that are the result of mistakes are placed in this special account. The corresponding profit or loss is kept as a negative or positive balance. There are usually separate error accounts for each broker. Most brokers are personally responsible for any negative cash balance in their error account, and a positive cash balance is usually kept on the books as a safeguard against future errors.

Now, another consideration is the fill. Was the client filled at a better or worse price as a result of the error? Market orders are difficult to determine, because the fill prices might vary. Let's consider the following example:

The market was trading around 1401.50. We know that because the sell was filled at that price. A buyer at that time, however, might not have been filled at 1401.50, so the price might have been 1401.80 or higher depending on market conditions. Let's say that the offer at the time the order was entered was 1401.80. Three things can happen after a mistake is made: 1) the market can go higher, 2) the market can go lower, or 3) the market can stay the same.

If the Market Moves Higher

The broker buys two S&Ps at the market. The fill price is 1402.50. The broker moves one buy and one sell into the error account. The sell was 1401.50, and the buy is 1402.50. 1401.50 − 1402.50 = − 1. In the S&P 500, each full point is $250. The error account has a negative balance of $250.

The client should have been filled at 1401.80 but instead was given the price of 1402.50. The client was not at fault, so his or her account should be credited the difference in price. 1402.50 minus 1401.80 equals .70. .70 multiplied by $250 equals $175.

The broker must cash adjust the client's account by $175. The cash comes from the error account. The client will have a buy price at 1402.50 on the statement but will also show a cash adjustment of $175, which corrects the difference in balance. The error account will now have a negative balance of $450 ($175 + $250).

The price at which the client should be filled is determined by consulting the time of sales. Time of sales is a printout of all of the trades that occurred during the time frame of the error. The client should be awarded a fill price for the buy at a price level within the range of trade during that time period. The client should not have to accept any price that is unreasonable for that time period, and the broker should not have to offer any price that is unreasonable for that time period. Market orders make it difficult to determine the exact price; therefore, both parties should be willing to meet at a price in the middle.

To cash adjust an account means to add money to the balance in order to make up for a discrepancy in price. The difference in value between the actual fill price and the price at which the order should have been filled is credited to the account. You can also have a negative cash adjust.

If the Market Moves Lower

The broker buys two S&Ps at the market. The fill price is 1399.80. The broker moves one buy and one sell into the error account. The sell was 1401.50, and the buy was 1399.80. 1401.50 minus 1399.80 equals 1.70. The error account has a positive balance of $525 (1.70 × $250).

The client should have been filled at 1401.80 but was instead given the buy price of 1399.80, which is two points better. The client should not

complain, because the fill price is $500 better than it could have been. There is no cash adjustment.

Scenario Two: Buy-Sell Error.

Broker: "OK, you sold one S&P at the market."
Client: "OK."

Two things happened here. First, the broker made a mistake by writing the order down incorrectly, and second, the client did not notice that the broker gave the fill as a sell and not a buy, as he or she had previously intended. An error that occurs in this manner can go undetected for an entire day or longer if neither party is paying attention. A colleague of mine had a $30,000 error of this nature.

If the trader was initiating a position, this error might be discovered when he or she calls back to liquidate what was thought to be a long position. Or, the error could be compounded if the trader calls to sell what he or she thought was a long position and then ended up with two short positions.

Hopefully, the error will be detected toward the close when the floor calls to check out with the broker, so that the situation could be corrected before the market closes. If not, then the error might be detected when the client receives the e-mail confirmation of the positions that evening. Otherwise, the next opportunity is the following morning when the broker checks out the ticket from the previous day.

In some cases, the error will trigger a margin call if the trader does not have enough money in the account to support two positions (two sells, for example) and is usually flat and out of the market at the end of each day. In the morning, always check the accounts with margin calls.

The problem here is that the broker wrote the sell as a sell, although the ticket should be a buy. So, unless the broker recognizes the trade as an error, the ticket and the trade will match and will not appear as an error at all. Not until the broker notifies the client, or until the client recognizes the mistake, can the situation be remedied.

Once the error is recognized and confirmed, it must be corrected. The manner of position and monetary compensation are similar to what we mentioned earlier, except that now a split might be involved.

2/3 1/3 Split

Both the trader and the broker are responsible for getting orders right. In this situation, there are three chances to catch the error. When the client says "buy" and the broker repeats "buy," there is no error. When the broker places the order as a sell and gets a confirmation of a sell, however, the broker has erred. When the broker reports the fill as a sell and the trader agrees, the trader has erred.

Because there are three chances for a mistake and the broker made two of the mistakes, this situation will likely be negotiated at a 2/3 1/3 split. Any losses that result are 1/3 the responsibility of the trader.

50-50 Split

Client: "Buy one S&P at the market."
Broker: "Sell one S&P at the market?"
Client: "Yes."

In this situation, the client placed a buy and the broker immediately repeated sell before placing the order. The client agreed to the trade; therefore, the error becomes a 50-50 split. Both the trader and the broker are equally responsible.*

These split negotiations are not set in stone. If two parties cannot agree on a price, the negotiations might advance to management and then on to arbitration. More often than not, it is better to come to the quickest settlement possible so that both parties can continue with their business. Errors are a fact of trading and should not escalate into emotional whirlwinds for either party.

Broker Orders a Sell; Floor Clerk Executes a Buy

This situation is similar to the previous scenario, except that the negotiations will be between the broker and the floor clerk. The broker is responsible for getting the best possible price for the customer. Although the floor clerk has made the error, the impact of the error is still reflected in the client's account. The incorrect fill is posted to the client's account, and all cash adjustments belong to the client.

The broker should push to get the matter cleared as quickly as possible. There are several ways in which the attempt to correct this situation could become complicated:

Broker: "Sell one market."
Floor: "Sell one market?"
Broker: "Yes."
The clerk executes a buy on accident.
Floor: "Bought one at 1401.00."
Broker: "That was a sell!"
Floor: "@##**&&%%!!!"

First, the floor clerk needs to quickly confirm that the order was indeed filled as a buy. Then, the floor clerk needs to sell two at the market as quickly as possible. Meanwhile, the broker's client is waiting on hold and is probably getting edgy. When the sell is reported to the broker, the broker needs to assess whether or not the fill is still good. If the mistake has enabled a better fill for the client, the broker should report the fill to the client as is. If the fill resulted in a bad fill for the client, the broker must report the fill and explain to the client what occurred.

*In most "full service" relationships the broker may be more likely to accept the cost of an error as the client is paying a premium in commissions specifically to avoid mistakes like these.

The broker must never criticize the floor clerk or make the floor clerk look bad in the client's eyes. All futures professionals must maintain the integrity of the futures industry and understand that mistakes happen. The client must not be given a bad impression of an industry participant unless there is due cause. In this situation, it was an honest mistake—and the client should be assured that the situation will be remedied.

The floor clerk will switch the error and offsetting trade to the error account and give the correct fill and price to the broker:

Floor: "OK, we sold two at 1390.10; you get one of them."

As soon as possible, the floor clerk will check the floor time of sales to decipher the correct fill for the transaction. The credit, if any, will be awarded to the client's account. Sometimes there is a lag of a day or two before the credit hits the client account. The client should be forewarned of this possibility so as not to arouse any more confusion:

Broker: "You sold one at 1390.10; that is the price you will see on your statement. The floor will adjust your account for the cash difference. It may take one additional day to hit your account. The floor apologizes for the mistake."
Client: "OK."

The broker serves as a medium between the client and the floor. Part of the broker's job is to act as a representative for the client and to uphold his or her rights as a market participant. Trading is hard enough as it is, so the broker should try to make the process as smooth as possible.

Client Exits Trade and Forgets to Cancel Stop

Many new traders assume that if a position is liquidated, all outstanding orders pertaining to that trade are automatically cancelled. This statement is not true. All orders entered by the client are ultimately the client's responsibility. In other words, any trade that is the result of a forgotten order belongs to the client. A discount desk is not likely to be capable of remembering every client's position and corresponding order. A full-service broker is more likely to catch these situations before they become errors.

Client: "I want to get out of sugar. Sell one October sugar at the market."
Discount desk: "You want to sell one October sugar at the market?"
Client: "That is correct."
Desk: "You sold one October sugar at 5.57."
Client: "Thanks."

Two days later . . .

Discount desk: "Mr. Client?"
Client: "Yes?"
Desk: "On open order number 5-7-9, you sold one October sugar at 4.90."

Client: "But I got out of sugar!"

Desk: "This is a stop order, sir. Did you cancel your stop?"

Client: "No, I guess I didn't."

In this situation, the client is now short one contract of sugar at 4.90. The client has the choice as to what to do with the trade, but because this situation was a surprise, the trade is exited immediately and at the market:

Desk: "Sir, you are short sugar. What would you like to do?"

Client: "Sell one sugar at the market."

Desk: "Sir, if I sell one sugar at the market, you will be short two."

Client: "Ugh! Buy me one October sugar at the market."

The client is responsible for the profit or loss associated with this mistake, as well as for the additional commission. Ideally, if the same situation occurred with a personal broker, the mistake would be avoided. You have no guarantee of avoiding this mistake under any circumstances, but the idea of paying extra commissions is to help avoid simple mistakes.

Client: "I want to get out of sugar. Sell one October sugar at the market."

Broker: "You are long one sugar and you wish to sell it?"

Client: "Yes."

Broker: "Do you have a stop or target working?"

Client: "Yes, I do. I have a stop."

Broker: "OK, I will sell one October sugar at the market and cancel open order number 5-7-9 to sell one October sugar at 4.90 on a stop."

Client: "Thanks."

Broker: "You sold one October sugar at 5.11. I cancelled your stop. Always remember that open orders are working until either filled or cancelled."

Client: "OK. I will make a note of it."

Again, all orders entered by the client are the client's responsibility (discount or full-service). A full-service broker earns the extra dollars by being diligent, however, and should take pride in preventing errors and educating clients.

Floor Broker Misses a Stop or Limit Order. The first sign that this situation has occurred is if it takes an extraordinarily long time for a fill to be reported. If you are expecting a fill on a ticket and you do not hear back in a timely fashion, be proactive and check the order. Do not wait until after the market has closed. By then, the floor broker might have left for the day—and you will not get a resolution until the following morning.

Floor brokers are busy people. They have a lot of orders to execute throughout the trading day. Occasionally, they make a mistake and are financially responsible for that mistake. If a floor broker misses a trade,

he either forgets to fill it or notices it much too late. The broker will fill the trade as soon as possible and credit the client any missing cash.

Broker or trader: "I am looking for a fill on ticket 4-5-6."

Floor: "OK, what was it doing?"

Broker or trader: "The order was selling two contracts of the June T-note at 99-05."

Floor: "OK. I see it here. I will check the order."

Floor: "Broker says he missed the trade. You sold two June T-notes at 99-03. Broker will cash adjust the account four ticks times two, or $125."

Broker or trader: "Sold two at 99-03, expect $125. Thanks."

The trade will be punched into the trader's account as a sell of two contracts at 99-03. Within a day or two, a cash credit of $125 will appear on the statement as well. The broker has the responsibility to make sure that the client gets his or her money from the floor. If the order missed were a stop order, the floor broker would fill the trade as soon as possible and then check the time of sales to determine the amount of the cash adjustment.

Open Order Placed as a Day Order. *All orders are day orders unless otherwise specified.* If the client enters a stop and wishes that stop to remain in effect for longer than one day, the order must be placed as a *Good-Until-Cancelled* (GTC) order. If a broker takes an order as a GTC, he or she must also enter it with the floor as a GTC. If both steps do not occur, the order will likely be assumed to be a day order and will be dead at the end of the day.

A dead order is a day order that was not filled during the session. This order is no longer working and is filed away for record. A dead order can also pertain to any existing orders on a contract that has expired. All orders pertaining to the expired contract are considered dead.

The best way to catch this mistake is to check your open orders at all times. Also, look through all of the open positions that you have and confirm that there is a correct and corresponding open order stop and/or target.

Client: "I am looking for a fill on order number 3-4-5."

Desk: "What was it doing?"

Client: "It was selling one contract of July soybeans at 563 on a stop."

Desk: "We don't have that order working. Was it a day or open order?"

Client: "I am pretty sure I placed it as an open order."

Desk: "What day did you place the order?"

Client: "Monday."

Desk: "We show that order as a day order."

Client: "I am pretty sure I said GTC."

Desk: "We can confirm that by checking the tape. Right now we need to take care of this problem. July beans are trading at 559. Do you wish to sell one now?"

This question is important. The desk absolutely must confirm whether or not the client wishes to sell the contract now. The client must give an answer.

The client says "Yes"—Because the market is trading below the original stop price, the client most likely wants to have sold the contract. If the client says "Yes," the broker will sell one contract at the market. Now that the trade is executed, the loss cannot exceed four cents (563 original order less 559, which is the actual fill price). This situation buys the client and desk some time to check the tape and determine who was at fault.

If the client did not specify the order as GTC, the client is at fault. He or she keeps the fill at 559. If the desk was at fault and placed the order incorrectly, the client gets the fill of 559 and is cash adjusted to the appropriate fill price. (Most likely the price will be 563, unless the market was moving quickly at the time. In this case, the desk will consult the time of sales and offer the client a reasonable fill price.)

If the client does not want the trade, then he or she must leave it as is. The client cannot come back two days later, when July soybeans are at 542, and say that he or she wants a fill at 563—regardless of who was at fault. Even if the tape shows that the desk made the error, if the client decides that he or she does not want the fill, he or she cannot come back later and demand one.

Whenever a miscommunication has occurred, the desk and client must come to a quick and immediate agreement in order to prevent further losses. In this situation, the client might have been slightly relieved that the stop was not filled, because upon further review, he or she did not want to sell beans at that price. The client might have chickened out or planned to change the price. Either way, once the client accepts and agrees that the order should not be filled at that very moment, there is no recourse at a later date.

Both parties must confirm either decision on a tape-recorded line in order to prevent any further bereavement.

Client Calls Broker and Cancels Open Order; Broker Forgets

Client: "Hi Sally. This is Jim."

Broker: "Jim! I am totally jammed. I have the floor on the other line. How can I help you?"

Client: "I just want to cancel my open order in OJ."

Broker: "No problem. I'll take care of it. I'll talk to you later."

The broker was obviously busy at the time and did not take the appropriate measures to ensure proper order entry.

Two days later . . .

Broker: "Jim, this is Sally. You sold five contracts of November OJ at 80 cents."

Client: "I cancelled that order two days ago."

Broker: "You did? I don't remember."

Client: "Yep. I called you around 9 A.M. You were busy, remember?"

Broker: "No I don't. Do you want this trade?"

Client: "No. That's why I cancelled it."

Broker: "OK. I need to cover this. I'll get back to you later."

The broker must now buy five contracts of OJ at the market. Then, if she is still convinced that the client had not called, she needs to check the tape of two days ago. In this situation, you can see how important it is to cover the trade immediately. Once the trade is liquidated, the broker can afford some time to check on the error. She is confident that the loss cannot exceed the difference between the two fill prices no matter what.

Once the broker is convinced that the mistake is hers, she must put both the buy and the sell into the error account. Because the client did not want the trade, all of the profit or loss belongs to the broker. The client cannot come back and say that he now wants the short orange juice after he has noticed that the market has fallen, regardless of who was at fault.

The broker will call the client and assure him that he was correct and that he is not responsible for the position. The lesson here is that it is always of the utmost importance to write down each order. When a client refers to an order, pull the ticket and put it in front of you. If the client makes a change, note it on the ticket and time stamp it. Repeat to the client precisely what you have written, not what you heard.

Many brokers assume that they will simply remember that the trade was a buy or a sell or that they will remember to cancel an order before the close. Do not count on your memory if the market is busy. Be diligent at all times. In fact, more errors probably occur when markets are slow, because brokers and clerks let their guard down and lose their groove. Be careful.

Quantity Disparity

Client: "Buy two S&Ps at the market."

Desk: "Buy *uh* S&P at the market?"

Client: "Correct."

Desk: "Filled at 1325.00."

Client: "Thanks."

A few minutes later . . .

Client: "Sell two S&Ps at the market."

Desk (different clerk): "Sell two S&Ps at the market?"

Client: "Correct."

Desk: "Filled. You sold two, a pair at 1328.50."

Client: "Thanks."

The client now thinks that he is flat and out of the market, when in fact he is short one S&P. The first clerk only bought one contract, and the second clerk sold two.

The first clerk made two mistakes. First, he or she obviously heard "one" when the client placed the order, but repeated "uh." "Uh" is not a number. If the clerk heard "one," he or she should have said "one." That might have given the client a better chance to catch the mistake before it was even entered.

The second mistake that the first clerk made was not repeating the details of the trade back to the client when the order was filled. All he or she said was, "Filled at 1325.00." The clerk did not indicate the quantity or whether or not it was a buy or a sell. Again, if he or she had done so, the error might have been caught quickly.

The second clerk performed perfectly. To verify the quantity as a two-lot, the clerk repeated, "Sold two, a pair at 1328.50." There is no question that this order was for two.

The client did not catch the first clerk's mistake. As a result, the client is short one S&P. This situation might not be discovered until the desk checks out the trades with him or maybe not even until he receives his statement. This situation could be expensive.

Client: "My account shows that I am short one S&P and I should be flat."

Desk: "What orders did you place?"

Client: "I placed an order to buy two and then an order to sell two, both orders at the market."

Desk: "We show that the first order was a one-lot."

Client: "Well, it was a two-lot."

Desk: "OK. The S&P is at 1331.50. Do you want to buy one now? Do you want to be flat?"

Client: "Yes, absolutely."

Desk: "I will buy one at the market for you. Bought one at 1331.50. I will check the tape and get back to you."

Desk: "The tape reveals that you said two, but the clerk said "uh." We'll take this one and adjust your account accordingly."

Client: "OK."

Some might argue that the error is a split—that the client said "two" but the clerk did not (implying that the client is 50 percent responsible for the error). The trader bought one at 1325.00 and sold two at 1328.50. The second buy was at 1331.50 and needs to be cash adjusted to 1325.00. That is the difference of 6.50 points, or $1,625. If the two parties had agreed to a split, the desk would owe the client $812.50. What could have been a profitable trade of $1,750 (3.50 points × $250 × 2 contracts) was then reduced to $937.50 (3.50 points − 3.00 points = .50 points, or $125—plus the cash adjust of $812.50).

Limit Order Assumed to Be Filled Was Not Filled

Limit orders have one restriction: they are not guaranteed to be filled unless the market trades through the price—and then only if there has been enough time for the broker to receive the order. (Through the price means that the market trades above the sell price or below the buy price.)

If you place an order to sell one contract of corn at 2.34 and it is trading at 2.33, you are not guaranteed a fill unless corn trades at 2.34 ¼. Possibly, if the high on corn is 2.34, you will indeed be filled—but the fill is not guaranteed.

Also, if corn is trading at 2.33 when you call to place the order and then it jumps to 2.34 ¼ quickly and heads back down, it is entirely possible that you are not filled. The move might have been too early, and the broker did not have the ticket in time.

This situation is true whether you enter the order by phone or electronically. There are still steps that you must take before giving your order to the filling broker.

Electronic Order Entry

Online trading does not necessarily mean that your order is entered faster than if you called a broker. Unless you qualify for the service that sends orders directly inside the pit, odds are high that your order must first pass through a trading desk before it is sent onto the floor. Orders typically must be checked in order to confirm that there is enough margin in the account to place the trade. For this situation to happen, the trade must first print out the order at an order desk, then verify it and send it to the pit.

This situation might even be true when trading an electronic contract such as the E-mini. Many brokerage firms, for their own protection, verify all trades before they are submitted.

A broker or even a trading desk is keenly aware of the margin capacity of each client and does not necessarily need to pause before entering the order. Once a trader has proven himself or herself (via experience and/or capital), then he or she might qualify for direct floor access.

Waiting for the confirmation of a fill can be frustrating. On a busy day, floor brokers might be tied up and cannot give fill reports back to the desks in a timely fashion. Never assume that an order is filled, however, with out checking first. Most brokers and even some trading desks have quick access to the time of sales data. Or, they can at least look at the tick data on their computer screen. If the market trades through the price more than three minutes after the order was entered, then you can determine with reasonable confidence that the order was filled. If the market conditions are fast-market conditions, then it is still possible that the order was not executed.

Dirty Trick. One of the fastest ways to get a confirmation for a fill (floor brokers *hate* this situation) is to straight-cancel the order. If the order has been filled, any attempt to cancel it will be reported as *Too Late to Cancel* (TLTC). TLTC orders are reported quickly. If the order has not been filled, it will be cancelled. Do not abuse this trick, or else you risk annoying floor brokers (and that is certainly not advisable).

Another option is to cancel-replace the order. If the market has touched the limit price and the order looks like it will not be filled, the order could be cancelled and then replaced with another. The order could be replaced with a market order or another limit order.

Sometimes traders chase the market by cancel and replacing orders, following the market around. Again, this activity is not advisable for two reasons: 1) brokers become annoyed, and 2) it is a bad trading plan. Each time an order is entered or changed, there is a risk of error. The more times an order is changed, the more likely there will be a mistake. Brokers have the right to refuse business if it poses too many risks to their business. Also, successful trading requires discipline. If a trader is constantly chasing the market, that implies that he or she is changing the trading plan throughout the day. Changes in a trading plan should not be made based on emotion; rather, they should be made based on fact.

Often, when a limit order is filled, the trader will want to place an offsetting order (such as a stop or a target). Perhaps the limit order was a target price of an existing position, and the trader would like to cancel the corresponding stop. In either case, you should verify a fill before placing another order.

Using Limit Orders to Enter a Position. If a trader wants to sell corn at 2.33, place a stop at 2.37 and a target at 2.19 (all GTC). The orders should be entered as follows:

Sell one July corn at 2.33.

Place a GTC order to buy one July corn at 2.37 stop.

If the sell order is filled, then place a GTC target to buy one contract of July corn at 2.19.

Both the sell limit and the stop limit can be placed at the same time. The trader wishes to be short corn at 2.33 but wants to be out of the short position if corn trades at 2.37 or higher. The stop order cannot be filled unless the sell limit order is filled as well. In order for a stop at 2.37 to be filled, the market must trade at 2.37. In order for the market to trade at 2.37, it must trade above 2.33.

If the market gaps higher one day and opens at 2.38, both the sell and the stop will be filled at or near 2.38. The loss will be minimal, and the trader would not want to be short in any case. If the opening call is for corn to open higher, both of the orders can be cancelled before the open to avoid a fill at all. (This action must be performed with plenty of time before the open.)

The target order cannot be placed until the sell is filled. If all three orders were entered, it is possible that corn could trade down to 2.19 before it trades up to 2.33. In that situation, the trader would be long corn

from 2.19, when the original plan was to be short corn. A full-service broker can monitor the if-then situation for the client.

The order to sell at 2.33 GTC and the buy stop at 2.37 GTC can be entered onto the floor. The ticket for the target should be written and time stamped but not sent to the floor. Instead, the order should be attached to the receipts of the other two as a reminder that when a fill is returned on the limit sell, the target should then be entered.

Other types of if-then orders are OCO orders that the floor does not accept. Once the trader is short corn from 2.33, he or she has both a stop and a target working. The corn pit does not accept OCO scenarios, so it is up to the trader to cancel either the stop or the target once the other is filled. This process requires careful monitoring of the market.

A full-service broker can monitor the trade for the trader. Most brokers will accept if-then or contingency orders for a small premium in commission. If the trader requests for the orders to be OCO, the broker should staple the receipts of each order together and make a notation that one is to cancel the other. That way, if one order is filled, the broker knows to cancel the other. Do not rely on memory.

In more volatile markets, it is wise to put an alert on the computer that will beep when the market trades at either price. That way, the other order can be cancelled more quickly, and you can avoid a double fill. (Most real-time trading systems have an alert program.) Always confirm that the order should indeed be filled (not a glitch or fast-market conditions), then cancel the other order. The alert service saves time instead of waiting for the fill to be reported.

Multiple Day Trades; Losing Track of Your Position. Active day traders must take special care to record their trades and keep track of orders. If the trader loses track of the trades or forgets about an order, he or she might end up with an incorrect position in the account.

Imagine a broker who must keep track of the day trades and contingency orders of 20 or more active traders. The ability to monitor 20 different positions, all of the corresponding orders, and the margin level of every account (some brokers have more than 200 accounts) is taxing. Being successful requires incredible discipline, focus, and a lot of finesse.

When market conditions are wild and traders are active, each day trade should be tallied and accounted for throughout the day. Particularly, if the broker is a full-service broker, Accuracy is one of the value-added services.

Here is an example of a tally sheet for S&P traders (see Table 7-3).

Table 7-3 *S&P Positions*

Account	Buy	Sell
12345	//	/
12356	///	//
12367	/	///
12378	//	//

In this example, account 12345 has bought two and sold one so far, and he or she is long one. Account 12356 has purchased three and sold two, and he or she is also long one. Account 12367 has purchased one and sold three, and he or she is short two. Account 12378 has bought two and sold two, and he or she is flat.

Throughout the day, every fill ticket should be checked and matched to the tally sheet. Every fill for account 12345 should be kept together and checked to be sure that the net position is correct. Also, whenever there is time, the client should be asked what he or she thinks his or her net position is. For example, if trader 12367 calls and places an order to buy one, the broker should say, "I show that you are currently short two and you are placing an order to buy one. Is that correct?" The client should know whether that information is correct or not. Consider the following example:

Trader: "Account 12367, buy me one S&P at the market."

Broker: "I show that you are short two and you wish to buy one. Is that correct?"

Trader: "No! I am only short one!"

Broker: "Let's cover this trade and look into this further. You want to buy one at the market?"

Trader: "Yes."

Broker: "You are filled. Bought one at 1366.70."

Now, the broker needs to double check all tickets entered for 12367 and figure out why there is a discrepancy. Do not add insult to injury by overreacting and buying an S&P at the market, assuming that there is an error. Take the time to confirm.

There are a number of reasons for the discrepancy that do not involve having to offset the trade:

1. The order could be misfiled.
2. One trade counted for 12367 could actually belong to 12356.
3. The wrong account number was written on the ticket.
4. The last fill had not been reported.
5. The fill ticket went to the wrong desk.
6. A buy order is missing.
7. The tally sheet is incorrect.
8. The fill is hiding under some papers (sloppy).

If you have considered all of these possibilities, then take a moment to go through each trade with the client. Sometimes the trader is wrong and he or she made the mistake. Go through each ticket and confirm whether it was a buy or a sell, the price of the trade, and the time of the trade. The trader should also be keeping careful records. The error is likely to be spotted here.

If every possibility has been exhausted, cover the trade. Chances are that one sell order was entered as a two lot, or there is some mistake with

a limit or a contingency order. Check the tape when the market slows to find out who was at fault.

Sometimes discrepancies of this nature occur when there are multiple clerks at one desk. Traders should make a note of which clerk took which order, and brokerage desks should have a way to determine who took the order. (Usually, handwriting style is the easiest way to tell.)

Double Fills

A double fill is defined as any intended buy or sell that is filled twice. This situation can happen in a number of ways:

1. The client sells a contract at the market, then cancels the stop. The stop comes back too late to cancel, and the market order is filled as well.
2. The trader places an order to buy a contract at the market, then cancels a previous limit order to buy. The limit comes back too late to cancel, and the market order is filled as well.
3. An electronic order is lost in the system. The trader places another order, and they both come back filled.
4. A stop and a target for an open position are both filled in one day.

Many times, a trader will call to sell a contract at the market and then cancel the corresponding stop. This action is fine if the stop is far away from the price. If the market is close to the stop, however, it is better to place a cancel-replace order. A cancel-replace order instructs the floor broker to find the stop order and change it to a market order. That way, there is no chance that the stop might be filled at a later time. Electronic systems also accept cancel-replace orders. One reason why a trader might choose to sell at the market as opposed to a cancel-replace-sell-at-the-market is because it takes a bit longer to fill a cancel-replace order than it does to fill an outright market order. Again, if the order is close, it is better to do a cancel-replace. If a trader does not choose to do a cancel-replace, any resulting double fill will be the trader's responsibility. A full-service broker will likely prevent this mistake from happening, however.

The T-note is trading at 99-04.

Client: "Sell me one June T-note at the market."

Broker: "Do you have a stop or target working that you might need to cancel?"

Client: "Yes, a stop at 99-02."

Broker: "Let's do a cancel-replace, then. I will sell one June T-note at the market, canceling ticket number 345 which was to sell one June T-note at 99-02 on a stop. Correct?"

Client: "That's right."

Broker to the floor: "This is broker number 60. I have a cancel-replace. The new order is to sell one June T-note at the market, canceling out ticket number 345 which was to sell one June T-note at 99-02 stop."

Floor: "You wish to sell one June T-note at the market, canceling out ticket number 345, which was to sell one at 99-02 stop. Correct?"

Broker: "That's correct."

Floor: "OK. Hold for your fill."

In liquid markets, a cancel replace that goes to the market can also be flash filled. If the market is busy or not as liquid, the trade might need to go in on paper (which takes a little longer).

To go in on paper means that the order cannot be hand-signaled into the pit; rather, it must be physically brought to the broker.

1. A limit order that is close should also be cancel-replaced. If the trader places a market order and does not cancel the outstanding limit order, both tickets might be filled. Do not underestimate how quickly a market can move.

Trader: "Sell one June Dow at the market."

Desk: "Sell one June Dow at the market?"

Trader: "Yes."

Desk: "OK, you sold one June Dow at 11,090."

Trader: "OK, now please cancel my limit order number 445 which was to sell one June Dow at 11,100."

Desk: "You wish to straight cancel ticket number 445 which was to sell one June Dow at 11,100.50?"

Trader: "Correct."

Desk: "Mr. Trader? Ticket number 445 was too late to cancel. You sold one June Dow at 11,100.50."

Trader: "How did that happen? I canceled that order."

Desk: "I know sir, but the market traded through 11,100 just as we got off the phone, and your order was filled before it could be cancelled."

Trader: "So I am short two Dow?"

Desk: "That's right, sir. What do you want to do?"

Trader: "Cover one. Buy me one June Dow at the market."

The mistake and any resulting profit or loss in this example belongs to the trader. There is a possibility that the desk took too long to get the straight cancel to the floor; in which case, the trader might have some recourse.

Desk: "You bought one June Dow at 11,101."

Trader: "I think that order should have been canceled in time. Let's check the time of sales."

Desk: "I am sure that the market traded at your price immediately, but I will check the prices for you to be sure."

In this situation, the trader was at fault. The difference between 11,090 and 11,100 in a Dow Jones contract is small. I have seen the Dow surge 150 points (11,090 to 11,240) in about five minutes. Never assume that the order could not be filled. Always consider a cancel-replace.

2. It might seem as though all errors occur with pit trading, but there are as many possibilities for error with electronic order entry, as well.

Systems jam sometimes. Orders will then be lost somewhere in cyberspace. When you go to check for an order that has been entered, it will simply not be there. Systems also crash. For no reason at all, the network will go down. You will not know which orders have been executed and which orders have been lost. Some orders might be lost permanently, while others might pop up when the system recovers.

The biggest problem with electronic order mishaps is that no one is to blame. The client has entered the order correctly, but the system has shut down. If the order was supposed to go to the pits, the floor is not at fault because it did not receive the order.

When a trader opens an account, the disclaimer on the account forms specifically sites electronic mishaps and other "acts of God" as a no-fault situation. The trader must accept the risk of entering orders electronically. This statement does not mean, however, that a brokerage firm will not uphold the quality of its system by offering compensation. Instead, it just means that the firm is not required to do so.

If you are stuck in an electronic error, consider the following scenario. A trader places an order online to sell two June E-minis at the market. There is no reply from the system. The connection seems to be lost.

The trader needs to contact the administrator. Do not place another trade. The odds are high that the order is simply stuck in cyberspace, and when the system clears, the order will be executed.

Key-Punch Errors. Before reacting to what looks like an error, consider that the trade might have just been punched incorrectly. If it is punched incorrectly, it will hit the account incorrectly. The result might be an imbalance of positions, incorrect prices, or an inadvertent margin call.

Examples of key-punch errors include the following:

1. A buy that hits as a sell
2. A sell that hits as a buy
3. A trade in an account that does not belong
4. The account is missing a trade.
5. A call is punched as a put.
6. Incorrect month
7. Inadvertent margin-call
8. Too many trades in one account
9. A decimal point in the wrong place, which generates an extreme price imbalance

10. A fill from a trade that had not been reported. (This trade might actually be valid. Confirm before re-entering any orders.)
11. Trade price punched incorrectly

When checking trade tickets against positions, do not panic if they do not match. A key-punch error might have occurred. Even if the ticket appears to have been entered incorrectly, confirm the trade with the floor before covering the trade.

To eat a trade means to accept it as your error. To bust a trade means to take it out of one account and put it into the appropriate account. In our example, the appropriate account was the error account. In other examples, the trade might belong to another trader.

Slippage

Slippage is defined as the amount that the fill of an order differs from the intended price. A sell stop order in beans at 5.50 that is filled at 5.49 has one cent of slippage.

In volatile market conditions, the amount of slippage can be extraordinary. Never over trade. Brokers might have more lenient margin rules for day trading, but by no means are they required to let anyone trade more than a reasonable amount. Brokers can set their own day trading margins. Just because you find a broker who allows you to be careless with your money does not mean that you should be careless. Brokers should not allow clients to trade too aggressively, no matter how much they beg or fight. If a client is trading with limited capital, chances are that he or she does not have money to burn. If the client is limited on cash, it will be harder for the brokerage firm to get the money to repay his or her debits.

How to Avoid Errors.

1. Keep accurate records.
2. Go through open orders at least twice a week and whenever there is free time.
3. Call brokers and confirm open orders and positions.
4. Do not worry if you seem redundant; better safe than sorry.
5. If your broker calls you, call back.
6. If the floor calls you, take the call quickly.
7. Repeat orders clearly.
8. Do not use the word "uh" or "a" instead of "one." The order is to buy or sell "one" S&P at the market, not "a," "uh," or "an" S&P at the market.
9. Never ever assume anything.
10. Confirm discrepancies and potential misunderstandings.
11. Do not let the order flow overwhelm you. Precision is the key.

12. When markets are busy, you have even more reasons for ensuring accuracy.
13. When markets are slow, do not become lazy. Quiet markets breed carelessness (and consequently, errors).
14. Cancel-replace if the order is close.
15. Accept responsibility for your own mistakes.
16. Write what you want to say.
17. Look at what you have written, and read it exactly.
18. Repeat the order to the client as it is written, not what he or she said.
19. Accept errors as a part of the business. Settle them quickly, and move on.

Chapter 8

Options Trading

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Introduction

Options are an invaluable tool for the futures trader. Options can provide leverage and limit risk exposure. By utilizing options, you can dramatically increase your leverage and profit potential when the market makes a big move. You can also reap the benefits of static market conditions when you otherwise might not have been profitable. Several truisms and fallacies exist, and we should discuss these while we are learning about the options market.

For example, when you purchase an option, there is no question that your risk is limited to the amount of money that you spend. Also, while your risk is limited, your profit potential is absolutely unlimited. In my personal trading experience, I have seen options that were worth $25 explode to be worth $8,000 in a matter of days. I have seen an entire group of clients more than double their money with options in a few short weeks. I have also seen all of that money dwindle away almost as quickly as the clients made it.

The profitable example listed earlier keeps traders flocking to the options market, hoping for big gains. Windfall profits are few and far between, however. In fact, much more often than not, if you buy a $25 option you stand to lose that $25 time and time again. Ultimately, the options seller has the statistical advantage in the trading arena, simply because he or she is willing to take on much more risk.

What is risk, really? If you consistently buy cheaply from the money options that lose their value over time, are you being risky? Some traders I know would never consider buying a lottery ticket, but they will buy a $300 option time after time—hoping to hit "the big one." The odds of being profitable in that situation are worse than gambling in Las Vegas. But they do it again and again.

I am not saying that there is never a good opportunity to buy options. In certain market scenarios, leveraged option purchases are the correct play. Finding these opportunities takes effort and attention, as well as an investment in research materials.

What I would like to achieve in this chapter is to educate you on the basics of options trading. With a foundation of options understanding, you will maintain a realistic approach to your trading and will avoid getting drawn into get-rich-quick schemes. You will be able to determine whether or not a trading suggestion or idea has the possibility or probability of profit for which you are searching.

David Caplan, who founded the firm Opportunities in Options, wrote an interesting book called *The New Options Advantage*. While I do not agree that all of the trading methods mentioned in this book are appropriate for the average investor, Caplan makes some good points with respect to the psychology of options. We will mention those here.

There are three common terms associated with options trading that draw the inexperienced speculator into the market:

1. *Options provide a limited risk.* As I mentioned previously, it is absolutely true that when you buy an option, your risk is limited to the purchase price (plus any fees involved). You know in advance exactly how much money you could possibly lose. While that fact is comforting, what good is it if your odds of being profitable are slim? Buying out of the money options (which some firms will pressure you to do) has little chance of making you any money in the long run.

2. *Options are cheap.* You can always buy a cheap option, just like you can buy a cheap car. Both situations are likely to be more expensive in the long term, however. Just because something is cheap does not always mean that it is a good deal.

3. *Options offer tremendous leverage.* The advantage of leverage with respect to options trading can be great. If leverage is the only thing that impresses you, however, you might as well make a living from buying lottery tickets. In the lottery, you spend a little amount for the prospects of amounting huge sums. Your odds are about the same if you make a habit of buying $20 options.

There are also many misconceptions associated with options trading:

1. *If you buy an option and it goes your way, you stand to profit.* This situation is not always the case. When you buy an option, much of the expense is called time value. I call it the "fluff" in an options price. This fluff erodes over time. In order to be profitable, your option must gain in price beyond the amount that the fluff or time value depreciates. The fact that time value depreciates is a drag on your profitability, and the more time that passes, the more significant the impact. You can liken this situation to running up a down escalator; you must move quickly and aggressively in order to get ahead. Even if the market moves in your direction, you still might lose.

2. *If I sell options instead of buy them, I will profit consistently.* While it is true that the option seller has the odds in his or her favor, there is also a tremendous amount of risk associated with this practice. I compare this money-option selling to dollar bills along Lake Shore Drive in Chicago. You might know that Lake Shore Drive is a fabulous strip of road that stretches along Lake Michigan through Chicago. Imagine that there are thousands of dollar bills lined along the center median. All you have to do to retrieve this money is to run across the street, pick up a dollar, and run back. Then, you must repeat this action over and over again. This task is easy, right? You could be successful performing this activity for weeks on end, gathering hundreds of dollars a day. Sometimes you might bring home $1,000 a month, working only on the weekends. But what is the real risk involved? What happens if one day you cross the road and a car smacks you right from behind? You did not even see the car coming. Was the effort really worth it? Often, I have seen good traders—profitable traders—make a living from selling options. Often, the success of this type of venture is great enough that the trader forgets the real hazards of

the job and forgets to respect the leverage. One market move (often overnight) wipes the trader out. He or she is forced to begin rebuilding accounts all over again. While option selling can be profitable 80–90 percent of the time, that slim margin of error can cost you all of your profits and even more.

3. *Trading is a zero-sum game.* In theory, this statement is true. For every buyer, there is a seller. For every market dollar lost, a market dollar is gained. Often, 10–20 percent of the traders are taking the money from the other 80–90 percent who are losing. In addition, dollars are also lost to fees. Trading cannot take place without the help of a middleman. The exchange, the clearing house, the floor broker, the commission broker . . . everyone gets paid to participate in this business. If you are trading, you have to pay these fees regardless of how well you are able to negotiate a deal. On average, brokerage fees account for 15 to 20 percent of your trading account. In order to be profitable, you must have gains that exceed this amount. Another expense is research. If you want to be a profitable trader, you need to invest in your education. You might also subscribe to a data service or to research materials. Data and software cost money—often as much as $300 per month. The Internet has enabled many participants to lower these costs considerably. A little legwork in that arena could go a long way.

Let's begin now with our education about options. Options have been an elusive topic to most investors for quite some time—most likely because the perception is that they are too difficult to understand. Actually, this situation is quite the contrary. I compare learning about options to learning to ride a bike. You try to get on the bike, and then something just clicks. You suddenly get it, and once you learn it, you will never forget this skill. Consider the following sections as an opportunity to learn something extraordinary as an adult.

Option

An option is an investment vehicle that gives the option buyer the right, but not the obligation, to buy or sell a particular futures contract at a stated price at any time prior to the specified date.

The fact that it is called an option tells you everything that you need to know. An option is an option to buy or sell something. If you purchase that option, it is your choice whether or not you will exercise it within the time provided.

Call

The buyer of a call option acquires the right to purchase a particular futures contract at a stated price at any time during the life of the option. Buyers of call options hope to profit from an increase in the futures price of the underlying commodity.

Put

The buyer of a put option acquires the right to sell a particular futures contract at a stated price at any time during the life of the option. Buyers of put options hope to profit from a decrease in the futures price of the underlying commodity.

The easiest way to learn the difference between a call and a put is to think of a telephone. When you go to make a call, you pick up the phone. When you finish speaking, you put the phone down. When you buy a call, you want the market to go up (call up). When you buy a put, you want the market to go down (put down).

Strike Price

The strike price is also known as the exercise price. This price is the stated price at which the buyer of a call has the right to purchase futures or at which the buyer of a put has the right to sell a particular futures contract.

This price is a fixed number (it does not change). When you buy a $300 gold call option, you have the right to buy gold at $300, wherever it is trading. Of course, if gold is at $270, you might not wish to use your option. (Why buy at $300 when you can buy it at $270 on the open market?) The value of being able to buy gold at $300 is extremely valuable if gold is at $350, however.

Underlying Contract

An underlying contract is the specific futures contract that the option buyer conveys the right to buy or sell. With futures options, each option series is based on the price of a particular futures contract. For example, December COMEX gold options give you the right to buy or sell December COMEX gold futures (not February gold or October gold, and not December Chicago gold, but December COMEX gold futures).

You should note that there are often more months of options contracts than there are months of futures contracts. For example, the S&P 500 is a quarterly futures contract, but there are options available for every month. You must find out which option month applies to which underlying futures contract. As a rule, the option month is priced off the next available futures contract that does not expire during the options life.

For example, an April option in the S&P 500 is priced off the action of the June futures contract. If it were priced off the March contract, the March futures would expire before the option expired. Thus, you could not ever exercise the option, and it would be a futile investment.

Premium

The price that you pay to purchase an option is known as the premium. Premiums are open competition between buyers and sellers on the

trading floor of the exchange. (With computerized trading, the system matches the bids and offers that surround the last trading price.)

I always refer to the premium as the out-of-pocket expense of an option; i.e., what it actually costs. This expense is the variable of options trading with which you should be the most concerned. How much do you pay for an option, and how much do you sell it for in the end?

Premium = Intrinsic Value + Extrinsic Value

Intrinsic Value

The intrinsic value is the amount that an option is "in the money." A call option has intrinsic value if the futures price is above the strike price. A put option has intrinsic value if the futures price is below the strike price.

Intrinsic refers to what the option is actually worth. If you own the right to buy gold at $300 per ounce and that right (option) is expiring the next day, the option is of little value to you or to anyone else if gold is at $270. If gold is at $350, however, the right to own it at $300 has considerable value—$50 per ounce, in fact, which in futures trading amounts to $5,000. ($50 per ounce × 100 ounce contract = $5,000.)

A put option has intrinsic value if the futures price is below the strike price. If you have the right to sell corn at $3 per bushel and the market is trading at $2.50 per bushel, the right to sell it at a higher price has value. In this situation, it is worth 50 cents per contract, or $.50 × 5,000 bushels = $2,500.

In-the-Money, Out-of-the-Money, At-the-Money

Three terms are used to describe where an option is trading relative to its strike price: in-the-money, out-of-the-money, and at-the-money.

Say that you own a gold call option with the strike price of $300 and a corn put option with the strike price of $3. Consider the following examples:

In-the-Money

If an option has intrinsic value, it is said to be in-the-money. At expiration, the value of the given option will be whatever amount (if any) that the option is in the money.

Call Options. A call option is in the money when the futures price is higher than the strike price. An example is when the gold futures price is higher than $300 per ounce.

Put Options. A put option is in the money when the futures price is below the strike price. For example, this situation occurs when the corn futures price is below $3 per bushel.

Out-of-the-Money

A call option is out-of-the-money if the underlying futures price is currently below the option strike price. A put option is out of the money if the futures price is above the strike price.

Call Option. The gold futures price is below $300 per ounce.

Put Option. Corn futures are below $3 per bushel.

At-the-Money

An option is considered to be at-the-money if the current futures price is equivalent to the strike price. At expiration, an at-the-money option does not have intrinsic value.

Call Option. The gold futures price is at $300 per ounce.

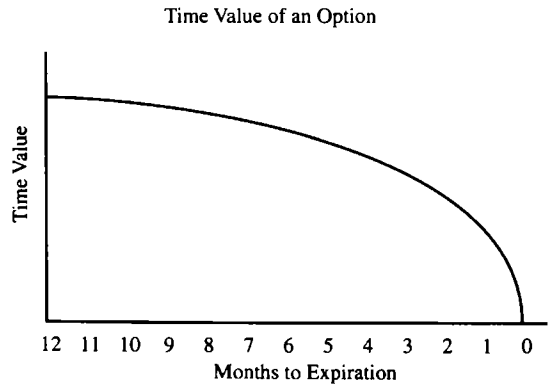
Put Option. The corn futures price is at $3 per bushel.

Extrinsic Value

Extrinsic value is also called the time value of an option and is the "fluff" in the price of an option. The extrinsic value is the premium value that exceeds the intrinsic value. This value is affected by the amount of time to expiration, supply and demand, volume, open interest of the options, the underlying contract's volatility, and more.

The most important thing to note about time value is that it depreciates over time. The rate of depreciation accelerates as the time approaches the date of expiration (see Figure 8-1).

Figure 8-1 *Time*



Here are some extrinsic value examples:

Call Option. If gold futures are trading at $310 per ounce and you own a $300 call, then you have extrinsic value. If the call is trading at $18, $10 of the price is intrinsic value and $8 of the price is extrinsic value.

Put Option. If corn futures are at $2.90 per bushel and the $3 put is trading at 15 cents, 10 cents of the option is intrinsic value and 5 cents of the option is extrinsic value. If an option is at the money or out of the money, all of the premium value is extrinsic value.

The expiration date is the last day on which the option can be either exercised or offset.

Exercising a call means that you elect to purchase the underlying futures at the option strike price. Exercising a put means that you elect to sell the futures contract at the option strike price.

An options position can generally be liquidated through an offsetting transaction prior to expiration. You will realize a net profit if the premium that you receive exceeds the premium that you pay for the option, plus any fees. Most traders opt for this approach.

When you purchase the rights conveyed by a particular option, it stands to reason that there must be some other party that is willing to sell them to you (option seller). The premium that you pay in order to acquire an option goes right to the seller, who agrees to grant those rights. The option writer, grantor, or seller takes the unlimited risk of the trade.

When you buy an option, you pay a premium price to the option seller. The only money required in this transaction is the cost of the premium and the transaction fees. There is no margin requirement, and your risk is limited to the initial cash outlay. There are three ways to exit your position:

1. You can sell the option in the open market. Your profit or loss will be the difference between what you paid for the option and what you got for it in return.
2. The option can expire. If you let an option expire out of the money, you will lose all of the premium spent plus the fees.
3. You can exercise the option and take a futures position. By taking this approach, you have now opened yourself up to the risk of a futures position. You should only perform this action if the option is in-the-money and if you plan to hold the position beyond the option's expiration date. Most importantly, if you choose to exercise an option, you lose the premium that you spent to originally buy the option.

Example: Exercising an Option. If an option that you own is in-the-money and you wish to exercise the option, remember the following bits about accounting:

Buy 300 gold call option at $10 per ounce.

Spend $1,000 to do it ($10 × 100 ounces per contract = $1,000).

Gold goes to $320.

Exercise your option. Get a long gold position from $300.

Now, you are required to post a futures margin of around $1,000 (your position now has a risk).

Sell gold in the open market at $320.

You receive profit from your futures transaction of $20 per ounce, or $2,000.

($320 − $300 = $20; $20 × 100 ounces = $2,000)

You lose the premium that you originally spent on your option of $1,000.

Your net profit is $1,000.

You should note that there will be a charge of two commissions for this transaction: one for the option purchase, and one for the purchase and sale of the futures position.

If you had just sold the option in order to liquidate, it would have been worth at least $20 per ounce ($2,000) at the time—because it was $20 in the money. You would have saved yourself a commission *and* avoided any additional risk of the position.

Gold could have fallen in price from the time that you exercised your option to the time that you were able to sell your futures position. Thus, your profit would have been less. Only exercise an option if you strongly believe that the price will continue in your favor beyond the expiration date.

Selling or Writing an Option

When you sell, write, or grant an option, you collect the premium. Your account receives a credit in the amount of the premium. If the option expires as worthless, you get to keep all of the money (less any fees). Because there is risk to the trade, you will also have to post margin as long as you have the position. Margin can be as high as the full futures margin but is often a small proportionate amount lower. There are three ways to offset a short option position:

1. *You can buy the option back.* Your profit or loss will be the difference between what you sold it for and what you had to pay in order to buy it back.
2. *You can be assigned a futures position.* If you are short an option that is in the money, you assume the risk that the option buyer will choose to exercise his or her right to own the futures position. Consequently, you might be assigned a futures position that is marked from the strike price. You can then choose to liquidate the futures position through an offsetting transaction in the open market. You will likely lose money in the futures position, but this loss is offset somewhat by the premium that you received.

Example: Being Assigned. If you are short an option that is in the money, you might be assigned a futures position. Here is an example of the accounting:

Sell one gold 300 call at 10.

Receive a premium of $10 per ounce × 100 ounces = $1,000.

Post a margin of $1,000 in order to hold your position.

Gold moves to $320.

The option buyer exercises the option (goes long gold at $300).

You are assigned a futures position short (the opposite side of the option buyer) from $300.

Buy gold back in the open market at $320.

Lose 300–320 = $20 per ounce × 100 ounces = $2,000.

Get to keep your option premium of $1,000.

You have a net loss of $1,000.

You will be charged a commission for the original option sale *plus* a commission for the futures transaction.

Your profit or loss in the futures position can fluctuate along with the market. If the futures contract is not expiring, you do not necessarily have to liquidate your position right away (provided that you have the margin to maintain it).

3. The option expires worthless. If the option expires out of the money, you get to keep all of the premium value of the option less any fees. You will no longer be required to maintain margin for the position.

We show an example of an option listing in Table 8-1.

Table 8-1

Strike	**Calls-Settle**			**Puts-Settle**		
Price	**Dec.**	**Mar.**	**May**	**Dec.**	**Mar.**	**May**
280	20 3/4	29 1/4	31 1/2	2 1/2	3 1/4	4 1/2
290	13 3/4	21 3/4	24 3/4	5 3/4	6 3/4	8
300	8 3/4	16	19	10 1/4	10 1/2	
310	5 1/2	11 1/2	14	17 3/4	16	
320	3 1/4	8	11	25 1/2	22	
330	1 3/4	5 3/4	8	34	29 1/2	....

(December corn contract closed trading at $2.98 per bushel.)

Example: Call. If you owned a December 290 call option and December corn finished at $2.98 per bushel, you can see that the 290 call option closed at 13 1/2. Of that 13 1/2, eight cents of the premium is intrinsic value, and 5 1/2 cents is extrinsic value or time value.

Example: Put. If you owned a December 310 put option and December corn closed at $2.98 per bushel, you can see that the 310 put option closed at 17 3/4. Of that 17 3/4, 12 cents of the premium is intrinsic value, and 5 3/4 cents is extrinsic value or time value.

Quiz

1. If you want protection against falling prices, would you buy a call or a put?
2. You purchased a $3.50 July CBOT wheat put for 15 cents a bushel. What is the a) underlying commodity, b) strike price, and c) premium?
3. If CBOT January soybean futures are trading at $6.75 per bushel and the January 650 call option is selling for 28 cents per bushel, how much of the premium value is intrinsic value, and how much is time value?
4. Would you be exercised against if you sold a CBOT May corn call and the CBOT May corn futures fell to $2.25?

Answers

1. If you expect the market to fall, you would buy a put. If you thought the market was going to rise, you would buy a call (call up, put down).
2. The underlying commodity is CBOT July wheat (*not* Kansas City wheat and *not* September wheat). The strike price is $3.50 per bushel. (You bought a put, so you have the right to sell July wheat at $3.50.) The strike price is also known as the exercise price. The premium paid is $.15 per bushel, or $1.5 × 5,000 bushels = $750.
3. Because this option is a call option and soybeans are trading above the strike price, the option is in the money by $.25 ($6.75 − $6.50). The premium equals the intrinsic value minus the extrinsic value. Thus, the intrinsic value is $.25, so the extrinsic value or the time value is $.03 ($.28 = $.25 + x *or* x = $.28 − $.25).
4. If you sold a $2.40 call option and the futures fell to $2.25, the option is out of the money and is not likely to be exercised. This option is what you want as a seller, writer, or grantor. The answer is no.

Tips of the Trade

- Option premiums are affected by market conditions. Do not buy an option when a market has been volatile, and do not sell options when the market has been quiet.
- 80 percent of all options expire as worthless; the other 20 percent can wipe you out if you are not careful.
- Trade in liquid option markets, which will enable better fills and enhance your profits.
- Option writing or selling is not for everyone. Be sure that you have more than adequate margin for the trade.
- Do not let a short option position get away from you. Consider using stop orders to maximize discipline.

- Time-value depreciation accelerates in the last 30 days of an option's life, and it is usually better to exit a long position before that time.
- Multiple option strategies involve multiple commission fees. Be certain that the fees do not take away too much from the ability to profit.

Option Strategies

There are a few options trading strategies that are important to add to your portfolio of knowledge. In this chapter, we will discuss the basics. If you plan on trading options seriously, I suggest that you continue your reading beyond just what has been covered throughout the end of this chapter.

Choose an option strategy by answering the following questions:

1. Which way is the market going?
2. How far is the market going?
3. By when is the market going?
4. Based on my personal account size and trading personality, which is the best strategy for me?

Buying Outright Options

Buying a Call

The market is expected to move higher in a short period of time. The advantage is the opportunity of unlimited profits with limited risk. The disadvantage is the time-value depreciation and other extrinsic forces that work against the position (see Table 8-2).

Table 8-2

Breakeven Price for Call Option
Option + Option + Transaction = Breakeven Price Strike Premium Costs Price
Profit Potential for Call
Unlimited
Maximum Risk for Call Option
Premium + Transaction Costs

Buying a Put

The market is expected to move lower in a short period of time. The advantage is the unlimited profit potential with limited risk. The disadvantages are the extrinsic forces of time decay and volatility working against the position (see Table 8-3).

Table 8-3

Breakeven Price for Put Option			
Option Price	− Option Premium	− Transaction Costs	= Breakeven Price

Profit Potential for Put
"Unlimited" (Limited to contract value)

Maximum Risk for Put Option
Premium + Transaction Costs

Synthetic Option Positions

Synthetic Call

Buy a futures contract, and buy a put. The advantage is the unlimited upside of futures position without the downside risk. A synthetic call is often used instead of outright futures and a protective stop. This call is ideal when market nears a bottom and is expected to rise or when market conditions are volatile. Use a put option in lieu of a stop (see Table 8-4).

Table 8-4

Breakeven Price for Synthetic Call			
Futures Strike	+ Option Premium	+ Transaction Costs	= Breakeven Price

Profit Potential for Synthetic Call
Unlimited

Maximum Risk for Synthetic Call
(Value of Futures Price − Strike Price) + Premium + Transaction Costs

Synthetic Put

Sell a futures contract; buy a call. Use this option when you want the virtually unlimited profit potential of a short futures position without the risk. Synthetic puts are often used instead of outright futures and a protective stop. This tool is ideal when the market nears a top and is expected to fall or when market conditions are volatile. The call option is used in lieu of a stop. See Table 8-4.

Table 8-4

Breakeven Price for Synthetic Put

Futures + Option + Transaction = Breakeven Price
Strike Premium Costs

Profit Potential for Synthetic Put

"Unlimited" (Limited to contract value less premium and fees)

Maximum Risk for Synthetic Put

(Value of Futures Price − Strike Price) + Premium + Transaction Costs

Synthetic Futures Position

Synthetic Short Futures

Sell a call option, and buy a put option. Essentially, this position is a short futures position. The advantage is a potentially smaller margin requirement with unlimited gains. The biggest advantage is that it can be used to offset the risk of a long futures position that is locked limit against you (see Table 8-5).

Table 8-5

Breakeven for Synthetic Short Futures Position

Strike Price − (Net Premium Received) − Transaction Cost

Maximum Risk

Unlimited

Maximum Profit

Unlimited

Synthetic Long Futures

Sell a call option, and buy a put option. Essentially, this position is a long futures position. The advantage is a potentially smaller margin requirement with unlimited gains. The biggest advantage is that it can be used to offset the risk of a short futures position that is locked limit against you (see Table 8-6).

Table 8-6

Breakeven for Synthetic Long Futures Position
Strike Price + (Net Premium Received) + Transaction Cost
Maximum Risk
Unlimited
Maximum Profit
Unlimited

Bull Spreads

Bull Call Spread

Buy a call of a lower strike price, and sell a call of a higher strike price in the same contract month. This bullish strategy is used when the market is expected to rise over a longer period of time. By selling the higher call option, you:

1. lower the cost of entry
2. lower your capital risk
3. lower your profit potential

This strategy is good to use if the market is expected to rise, but over a longer period of time. Your cost of entry is lowered because your account receives a credit of the amount of the premium of the option sold, which offsets some of the cost of the option purchased. This approach also helps neutralize some of the time decay that is inherent in options.

Your profit potential is limited, because although the long option gains in value, the short option begins to work against the position as the market rises. The profit potential is the value of the difference between the strike prices less the premium paid (plus fees). See Table 8-7.

Table 8-7

Breakeven for Bull Call Spread
Lower + Net Premium + Transaction Cost Strike Price
Maximum Risk for Bull Call Spread
Net Premium + Transaction Costs
Maximum Profit Bull Call Spread
Value of: (Long Call Price – Short Call Price) – Premium – Transaction Cost

Bull Put Spread

A bull put spread is used when the market is not expected to fall over a period of time. This position does well if the market rises or trades sideways until the options expire. You should sell a put option of a higher strike price and buy a put option of a lower strike price. By selling the higher put option (and presumably the more expensive one), you receive a credit for putting on the position. By buying the lower put option, you limit the risk of the position. The risk of the position is limited to the difference between the strike prices less the premium received (add in commission costs, as well). The primary advantage of the position is that it takes advantage of the time value depreciation of an option without the exposure to unlimited risk (see Table 8-8).

Table 8-8

Breakeven for Bull Put Spread
Short Put Strike Price – Premium Received + Transaction Costs
Maximum Risk for Bull Put Spread
Value of: (Short Put Price – Long Put Price) – Net Premium Received + Transaction Costs
Maximum Profit of Bull Put Spread
Net Premium Received – Transaction Costs

Bear Spreads

Bear Put Spread

Buy a put of a higher strike price, and sell a put of a lower strike price. This bearish strategy is used when the market is expected to fall over a longer period of time. By selling the lower put option, you:

1. lower the cost of entry
2. lower your capital risk
3. lower your profit potential

This strategy is good to use if the market is expected to fall, but over a longer period of time. Your cost of entry is lowered because your account receives a credit of the amount of the premium of the option sold, which offsets some of the cost of the option purchased. This approach also helps neutralize some of the time decay that is inherent in options.

Your profit potential is limited, because although the long option gains in value, the short option begins to work against the position as the market falls. The profit potential is the value of the difference between the strike prices less the premium paid (plus fees). See Table 8-9.

Table 8-9

Breakeven for Bear Put Spread
Long Put Price − Premium Spent − Transaction Costs
Maximum Risk of a Bear Put Spread
Premium Spent + Transaction Cost
Maximum Profit of Bear Put Spread
Value of: Difference Between the Strike Prices − Premium Spent − Transaction Costs

Bear Call Spread

A bear call spread is used when the market is not expected to rise over a period of time. This position does well if the market falls or trades sideways until the options expire. Sell a call option of a lower strike price, but buy a call option of a higher strike price. By selling the lower call option (and presumably the more expensive one), you receive a credit for putting

on the position. By buying the higher call option, you limit the risk of the position. The risk of the position is limited to the difference between the strike prices less the premium received (add in commission costs, as well). The primary advantage of the position is that it takes advantage of the time-value depreciation of an option without the exposure to unlimited risk. See Table 8-10.

Table 8-10

Breakeven for Bear Call Spread
Strike Price of Short Call + Premium Received − Transaction Costs
Maximum Risk of Bear Call Spread
Value of: Difference Between the Strike Prices − Premium Received + Transaction Costs
Maximum Profit of Bear Call Spread
Premium Received − Transaction Costs

Selling Options Outright

By selling options outright, you get the full advantage of the time-value depreciation of the option. The disadvantage is that you have the potentially unlimited risk of the trade. Using stringent risk-management techniques (such as stop options) is wise in order to ensure discipline. Short option positions require margin deposits, and if the market moves far enough against the position, a margin call might occur.

Short Call

A short call is used when the options are perceived to be overvalued due to the volatility of the underlying futures contract. Trade does well if the market does not exceed the strike price to the upside prior to expiration. If the option expires as worthless, the seller gets to keep all of the premium less transaction costs (see Table 8-11).

Table 8-11

Breakeven of Short Call
Strike Price + Premium Received − Transaction Cost
Maximum Profit of Short Call
Premium Received − Transaction Costs
Maximum Risk of Short Call
Unlimited

Short Put

A short put is used when the options are perceived to be overvalued due to the volatility of the underlying futures contract. Trade does well if the market does not exceed the strike price to the downside prior to expiration. If the option expires as worthless, the seller gets to keep all of the option premium (see Table 8-12).

Table 8-12

Breakeven of Short Put
Strike Price − Premium Received + Transaction Costs
Maximum Risk of Short Put
"Unlimited" (Limited to contract value less premium received plus transaction costs)
Maximum Profit of Short Put
Premium Received − Transaction Costs

Short Strangle or Straddle

In a strangle, sell an out-of-the-money call and sell an out-of-the-money put. In a straddle, sell an at-the-money call and an at-the-money put. Positions do well if the market stays quiet or if it stays within a trading range until the options expire. This strategy takes advantage of time-value depreciation. Refer to Table 8-13.

Table 8-13

Breakeven Prices for a Short Strangle or Straddle
Call side:
Call + Total Premium Received (from call *and* put) + Transaction Costs
Strike
Price
OR
Put side:
Put − Total Premium Received (from call *and* put) − Transaction Costs
Strike
Price

Profit Potential for Long Straddle or Strangle
Premiums Received − Transaction Costs

Maximum Risk for Long Straddle
Unlimited

Covered Futures Positions

Covered Call

A covered call refers to a long futures position with a short higher call option. This strategy is used to capture premiums in a bullish market position and takes advantage of the depreciation of options over time, in addition to adding value to a profitable futures position. A covered call offsets some, but not all, of a futures position (see Table 8-14).

Table 8-14

Breakeven of Covered Call
Futures Purchase Price − Premium Received + Transaction Costs
Maximum risk of Covered Call
"Unlimited" (Limited to contract value − premium Received + transaction costs)
Maximum Profit of Covered Call
Value of:
(Strike Price − Futures Purchase Price) + Premium Received − Transaction Costs

Covered Put

A covered put involves a short futures position and a short lower option. This strategy is used to capture premiums in a bullish market position and takes advantage of the depreciation of options over time, in addition to adding value to a profitable futures position. A covered put offsets some, but not all, of the risk of a futures position (see Table 8-15).

Table 8-15

Breakeven of Covered Put
Futures Selling Price + Premium Received − Transaction Costs
Maximum risk of Covered Put
Unlimited
Maximum Profit of Covered Put
Value of: (Futures Selling Price − Strike Price) + Premium Received − Transaction Costs

Breakout Strategies

Long Straddle or Strangle

A straddle involves buying an at-the-money call option and buying an at-the-money put option. A strangle involves buying an out-of-the-money call option and an out-of-the-money put option. Both positions have limited risk and unlimited profit potential and do well if the market makes an explosive move in either direction (see Table 8-16).

Table 8-16

Breakeven Prices for a Long Straddle or Strangle
Call side: Call + Total Premium Spent (on call *and* put) + Transaction Costs Strike Price OR Put side: Put − Total Premium Spent (on call *and* put) − Transaction Costs

Strike Price	Profit Potential for Long Straddle or Strangle	Maximum Risk for Long Straddle
Total Premium Spent (on call *and* put) + Transaction Costs	Unlimited	Total Premium Spent (on call *and* put) + Transaction Costs

Straddles and strangles can also be sold. This strategy works well if the market does not move much one way or the other before the options expire.

Quiz

1. If I buy a July corn $2.70 call option for 15 cents, what is my risk, breakeven, and profit potential? (Assume transaction fees of $50.)
2. If I buy a July corn $2.70 put option for 15 cents, what is my risk, breakeven, and profit potential? (Assume transaction costs of $50.)
3. If I place a synthetic call position in which I purchase a March soybean futures contract at $5 per bushel and simultaneously buy a March soybean $5 put at 16 cents, what is my risk, breakeven, and profit potential? (Assume that fees are $50 per round-turn.)
4. If I buy an at-the-money straddle in December COMEX gold and I pay $5 for the call and $5 for the put, where is my breakeven? What is my maximum risk? What is my profit potential? (Assume that gold is trading at $320 per ounce and commissions are $50 per round-turn.)

Answers

1. Buy a call July Corn at $2.70. Buy one $2.70 call at 15 cents ($.15). Commissions and fees are $50. The contract size is 5,000 bushels. Each tick of one cent ($.01) equals $50.

Value of premium:
$.15/bushel × 5,000 bushels = $750

Maximum risk:
$750 + $50 = $800

OR

Convert the commission cost into a value of cents per bushel. The commission is $50, divided by the contact size of 5,000:
$50/5,000 bushels = $.01 per bushel or 1 cent per bushel

Maximum risk:

$.15 per bushel + $.01 per bushel = $.16 per bushel.

$.16 per bushel × 5,000 bushels = $800.

Breakeven (at expiration):

$2.70 per bu. + $.15 per bu. + $.01 per bu. = $2.87 per bushel

Maximum profit:

Unlimited

2. Buy a put July Corn at $2.70 per bushel. Buy a July $2.70 put for $.15 per bushel. Commission and fees are $50. The contract size is 5,000 bushels. Each tick of one cent ($.01) equals $50.

Value of premium:

$.15/bushel × 5,000 bushels = $750

Maximum risk:

$750 + $50 = $800

OR

Convert the commission cost into a value of cents per bushel. The commission is $50. Divided that by the contact size of 5,000, and you have:

$50/5,000 bushels = $.01 per bushel or 1 cent per bushel

Maximum risk:

$.15 per bushel + $.01 per bushel = $.16 per bushel.

$.16 per bushel × 5,000 bushels = $800.

Breakeven:

$2.70 per bu. − $.15 per bu. − $.01 per bu. = $2.54 per bushel

Maximum profit:

The maximum profit is limited to the value of the contract. For example, if the value of corn went to zero, that would be the limit.

$2.70 per bu. × 5,000 bushels = $13,500

The value of corn is not likely to go to zero, but that is the effective maximum profit on one put option.

3. Synthetic call position. Buy a March soybean futures contract at $5 per bushel. Buy a March soybean $5 put for 16 cents per bushel. Commission and fees are $100 (one round-turn of $50 for futures and one commission charge for option purchased).

Breakeven price (at expiration of option):
Futures price + Premium + Fees
$5 per bushel + $.16 + $100 (or $.20 per bushel) = $5.18

Maximum risk:
The maximum risk is the value of the difference between the futures price and the strike price plus the premium paid and fees.
($5 futures price − $5.00 put) (0) + $.16 ($800) + $100 = $900

Maximum profit:
Unlimited

4. Buy a straddle. Buy December gold at $320 per ounce. Buy one December 320 call at $5. Buy one December 320 put at $5. Commissions are $100 (two options at $50 each). Convert the commissions to a price:

$100 per ounce divided by 100 ounces = Fees equivalent of $1 per ounce

Breakeven of long straddle:

Call side:
$320 strike price + Total premium of $10 + Fees of $1 = $331

Put side:
$320 strike price − Total premiums of $10 − Fees of $1 = $309

Maximum risk of long straddle:

Total premium spent + Fees
$10 per ounce ($10 per ounce × 100 ounces = $1,000) plus $100 = $1,100

Maximum profit of long straddle:

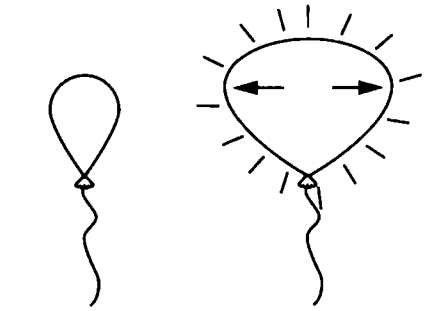
Unlimited

Conclusion

Which option position you choose depends on a number of different factors. We return to the questions, "Which way is the market going? How far? By when?" Also, you should ask, "Based on my personal account size and trading personality, which is the best strategy for me?" Always consider the following points.

Regardless if you are correct on the direction of the market, you can still lose money trading options. You might buy an option that is currently

Figure 8-2 *Blown-up balloon*



Normal market conditions – premiums calm good time to buy.

"Hot" market conditions – premiums inflated good time to sell.

overvalued, and although the market moved your direction, it never moved enough to make up for the loss in time value and calming of volatility. Time-value depreciation and declining volatility eat away at an option's value.

Try to look at option premiums as a blown-up balloon (see Figure 8-2). When the market is hot and futures prices are moving wildly, the premiums heat up and expand. Market gyrations are wild, and the options market prices in huge statistical moves. These conditions are rare, and option premiums tend to be expensive. When options are expensive, it is time to sell them. Take profits on long options or place orders on strategies that are net sellers of premiums. Another example would be to sell an out-of-the-money option against one that you already own in order to lock in a guaranteed profit. Hot market conditions are a good time to capture the volatility and have its eminent decline work in your favor.

We are not saying that a market that is volatile might not continue to be so for some time (soybeans during a drought, for example). Do not sell options outright at the first sign of a big move; rather, use option volatility in your favor by placing the strategy that is right for the current conditions. For example, in a bullish scenario, sell a put spread (bull put spread) or buy a call spread that will help neutralize some of the recent volatility.

Conversely, you want to buy options when the market is quiet. A market that has been quiet for a long period of time is usually preparing for a big move. During this time, option volatility declines—and options become relatively undervalued. This situation might be a good time to buy a call *and* a put to capture the anticipated move in either direction. (This technique is called a straddle—both options at same strike price.) Or, a strangle refers to options being on either side of the market price.

The key, of course, is to know when an option is overvalued and undervalued. Each market has its own normal level of volatility, and evaluations of overvalue and undervalue must be made against that level.

Data services provide this type of information. Some provide the information to you in real time, and others will update the information on a

weekly basis. If you plan to trade options seriously, you should understand the concept of volatility and learn to use it in your favor.

Different trading personalities will find that different option strategies work better for them. Some people have a low risk tolerance and will only be comfortable buying options. Option buyers can be profitable if they are buying options at the appropriate time. Other people will sell options. Statistically, option sellers have the odds in their favor. Without appropriate risk management, however, an option seller can lose his or her entire account (and more) on one swift market move. There are option trades that have the benefit of both statistical advantages and limited risk (bear call spreads and bull put spreads, for example), but some people find them to be too "boring." These people would rather take on more risk for the excitement of explosive profits.

Futures and options trading is an exciting field, and the opportunity for profit has attracted thousands of speculators into the business. The excitement will likely attract thousands more in the future. Ideally, we should remember that there is always a limit to how much a person is willing to risk in the market. Although everyone would like to be profitable all of the time, it is risk management that enables the options trader to withstand the long haul.

Chapter 9

Rules and Regulations

Introduction
The Commodity Futures Trading Commission (CFTC)
The NFA
Futures Industry Regulations
Additional Compliance Advice for
Salespeople in the Industry
NFA RULE 2-29

Introduction

In order to preserve the integrity of the futures markets, floor officials, clearing houses, brokerage firms, and brokers must follow very specific rules. The purpose of rules is to create efficient, liquid markets that are accessible by anyone who should choose to trade. Rules also protect the participants from fraud, theft, and irresponsible behavior. Rules are often reviewed and amended in order to reflect a growing and changing society.

The Commodity Futures Trading Commission (CFTC)

The futures industry began to attract the small speculator's interests in the early 1970s. Commodity prices were swinging wildly as the export markets grew. Trading volumes increased dramatically as new products such as metals and currencies became available. This growth attracted unethical practices as well, however, and there was a threat to the integrity of the futures industry. To adapt to this change, Congress established the *Commodity Futures Trading Commission* (CFTC). The CFTC is an independent federal regulatory agency with exclusive jurisdiction over futures trading. The mission of the CFTC is to protect market participants against manipulation, abusive trade practices, and fraud.

The CFTC reviews the terms and conditions of proposed futures and options contracts. Before an exchange can trade a futures and options contract in a specific commodity, it must demonstrate that the contract reflects the normal market flow and commercial trading practices in the actual commodity. The commission conducts daily market surveillance and can, in an emergency, order an exchange to take specific action or to restore orderliness in any futures contract being traded.

Commodity exchanges compliment federal regulation with rules of their own—rules covering the clearance of trades, trade orders or records, position limits, disciplinary actions, floor-trading practices, and standards of business conduct. A new or amended exchange rule can only be implemented upon CFTC approval. The CFTC might direct an exchange to change its rules or practices. The CFTC also regularly audits each exchange's compliance program.

The CFTC also seeks to protect customers by requiring registrants to disclose market risks and past performance information to prospective customers and by requiring customer funds to be kept in accounts separate from those maintained by the firm for its own use. Also, the CFTC requires customer accounts to be adjusted in order to reflect the current market value at the close of trading each day. In addition, the CFTC monitors registrant supervision systems, internal controls, and sales practice compliance programs. Each individual who is registered with the CFTC must also complete ethics training.

Companies and individuals that handle customer funds or give trading advice must apply for registration through the *National Futures Association* (NFA).

The NFA

The NFA is a self-regulated, CFTC-approved organization that was organized in 1982 with the purpose of establishing and enforcing high standards of business conduct within the futures trading industry. The NFA was designed to protect market participants and to help members meet their regulatory responsibilities.

Every firm or individual that conducts futures or options business with the public must be registered with the CFTC and must be a member of the NFA. The NFA performs the registration process on behalf of the CFTC. Member categories include the following: *Commodity Trading Advisors* (CTAs), *Commodity Pool Operators* (CPOs), *Futures Commission Merchants* (FCMs), *Introducing Brokers* (IBs), and *Associated Persons* (APs).

Futures Industry Regulations

In this chapter, we will discuss the rules and regulations that govern the futures industry. The first subject (and the most important topic with respect to futures industry and sales training) is compliance. John Walsh originally compiled the following material as part of an interview with Dan Roth, who currently serves as the general counsel for the CFTC. The information is intended to give you an overview of the major rules of the NFA regarding communications with the public and promotional material.

As a general guideline, those people who are selling any futures products should seek to ensure that all communications that they or their firm have with the public meet the same high standards that they would like from people who provide them with information concerning an investment. In most cases, this mutual relationship will avoid violations of the NFA's Rule 2-29, which requires the following:

1. Statements made in promotional material must be factually true. The member, when called on, must be able to document the accuracy of such statements.
2. Statements concerning the possibility of profit must be accompanied by an equally prominent statement of the risk of loss.
3. Any reference to hypothetical results that could have been achieved in the past by employing some particular trading system must be accompanied by a prescribed statement regarding hypothetical or

simulated performance results. The statement must be printed in capital letters. The statement essentially states that results of hypothetical track records by no means represent that any real-money account is likely to receive the same results.

4. Statements regarding actual past trading profits must mention that past results are not necessarily indicative of future results.
5. If statements about past performance mention a numerical rate of return, the rate of return figures must be calculated in a way that is consistent with CFTC regulation 4.21.
6. Statements about past performance must be representative of the actual performance for the same time period for all reasonably comparable accounts.
7. Statements of opinion must be identified as such, and they must have a reasonable basis in fact.
8. Members must have and must employ written procedures for reviewing and approving promotional materials produced and used by associates and employees.
9. Copies of promotional material, along with a record of their review and approval, must be maintained in a readily accessible location for at least three years from the date of last use.
10. Copies of promotional material must be filed with NFA immediately after their first use, if so required by the director of compliance.

Rule 2-29 prohibits the following:

1. The use of any promotional material that is likely to deceive or mislead the reader
2. Promotional material, whether written or presented verbally, that employs or is part of a high-pressure sales approach
3. The omission of any material fact, if the omission would make the promotional material deceptive or misleading
4. Any statement of that futures trading that is not appropriate for everyone.

What Does Rule 2-29 Cover? Section A of Rule 2-29, which basically bars fraud and high-pressure sales practices, applies to all communications with the public. Section B applies to promotional material.

What Does the NFA Consider Promotional Material? If one purpose of the communication is to sell something—explicitly or implicitly—to an existing or potential client, the communication is probably considered promotional material and is therefore subject to the requirements of Section B of this rule. Some examples of promotional material are as follows:

1. Sales or educational literature distributed to the public, whether prepared by a member, an associate, or by someone else
2. Advertising, which includes newspapers, magazines, radio, television, and direct mail

3. Phone solicitation, whether it is cold calls or in response to sales leads
4. Seminar presentations, meetings, and any advertising or promotional activity designed to encourage attendance at a seminar or meeting
5. Newsletters, reports, circulars, and so on
6. A prepared sales script, whether actually followed in making sales presentations or developed solely for training purposes

This list, by the way, is not meant to be all-inclusive.

Additional Compliance Advice for Salespeople in the Industry

All of Rule 2-29 is important, but in any communication, every salesperson must balance the potential for profit with the risk of loss. Any mention of the possibility of profit must be accompanied with an equally prominent statement of the risk of loss. This part of Rule 2-29 is intended to ensure that the audience for the material receives a balanced presentation and is clearly informed that the profit potential of futures and options trading is obtainable only because of the significant risk involved. The evaluation of equal prominence requires analysis of the overall impact of the piece. This evaluation is not determined by measuring size or type, counting the number of times that risk is mentioned, or comparing the total time spent discussing profit and risk (although these factors might be part of the final determination). This rule will not be used to inhibit honest promotional strategies that attempt to inform the audience that significant profit opportunities have existed (and will continue to exist) in these markets. The rule only requires that profit—past, present, or future—cannot be emphasized disproportionately, or that the risk of loss cannot be downplayed or hidden. Mention of profit might take many forms and is not limited only to the word *profit*. Past performance results showing gains or graphs depicting the growth of an account are just two examples that mention the possibility of profit; thus, there must be a balancing disclosure of the risk of loss. You must also realize that the requirements concerning the balance between profit potential and risk of loss are separate and distinct from rules that require a cautionary statement about hypothetical results (a statement that actual past trading results, if mentioned, are not necessarily indicative of future results). Thus, promotional material that discusses trading results and includes the required cautionary statement about hypothetical results might still be deficient because it lacks a balancing statement about the risk of loss. Additionally, video presentations and standardized oral presentations both have unique considerations relating to the balance of profit potential and risk of loss. Brief disclaimers at the end of these presentations might not satisfy the balance requirement. Often, 60-second advertisements are

run that stress profit potential with only a few brief seconds at the end showing a printed screen of qualifiers and warnings. Similarly, a salesperson might spend 10 minutes on the phone discussing a member's outstanding track record with a prospective client and conclude by informing the prospect that he or she will be sending important information concerning the markets and the risks involved. These types of presentations, which clearly tend to minimize or downplay the risk of loss, run contrary to the intent of Rule 2-29 and must be avoided. Finally, this discussion of balance should indicate that certain types of printed promotional material must be designed rather conservatively to comply fully with Rule 2-29. A short, three-line advertisement in the classified section of a local newspaper claiming a "40% Proven Track Record, Call Now For Details" or a postcard promising "Unlimited Profit Potential for Qualified Investors, Return This Card Now to Take Advantage of This Exciting Opportunity" do not meet the standards set by Rule 2-29. Advertisements such as these, with the primary intent of generating leads, should be carefully reviewed before their use.

What About High-Pressure Sales Tactics?

Rule 2-29 prohibits any communication with the public that is part of a high-pressure approach. High-pressure sales tactics are serious breaches of NFA's client-protection program and are dealt with swiftly and severely. In addition to violating high-pressure prohibition, most sales approaches of this type run afoul of many other provisions of Rule 2-29. These solicitations are generally deceptive, contain misstatements of facts or omit facts, lack balance, and include opinions that are not identifiable. Although there is no precise definition of a high-pressure solicitation, there are certain attributes that seem to be common in this type of solicitation. Each of these characteristics is not required to be present in order to indicate a high-pressure approach. Indicators of high-pressure tactics include the exaggeration of profit potential, past results, qualifications of the salesperson or member, and the urgency of making an investment immediately. Noticeably lacking in these approaches is any mention of the risk involved in the markets. If risk is mentioned, it is only mentioned so that the salesperson can downplay it.

What About Making Claims About Annual Rates of Return?

Members often wish to show annual rates of return for accounts that they have directed. Rule 2-29(b)(6) requires any rate-of-return figure to be calculated in a manner consistent with that required by CFTC regulation 4.21(a)(4)(ii)(F). This CFTC regulation sets forth the rate-of-return calculation for CPOs and CTAs, and all NFA members must follow this method. The rate of return, according to this method, is calculated by dividing the net performance for the month or quarter by the asset value at the beginning of the period. While members might feel that this calcu-

lation has its shortcomings, this method is the only one on which the rate-of-return calculations can be based. Rule 2-29 does not specify a calculation for an annual rate of return. Therefore, any member who cites an annual rate of return must be able to demonstrate that the calculation used is consistent with CFTC rule 4.21. Under any circumstances, a rate-of-return calculation must begin by using the CFTC-prescribed formula for rate of return for monthly or quarterly periods. A valid statistical formula can then be used to derive an annual rate of return. Also, words such as *average* or *compound*, when used in connection with rates of return, might require additional disclosure. Presenting an average return for a number of periods, when the individual returns for the periods have fluctuated widely, might be considered misleading if there is no clarification. Certain calculations are unacceptable, and NFA members cannot use them. Examples of methods that might be considered unacceptable are summing monthly or quarterly rates of return or dividing net performance for the year by the net asset value at the beginning of the year. Any method used must be accurately presented and adequately described in the promotional material. Of course, even a statistically valid method cannot be used if it produces a rate of return that is in some way misleading.

Other Claims That Could Get a Salesperson into Trouble. Several of these types of claims exist. One of the most popular claims that can cause problems is "Small deposits control large amounts of a commodity." In an effort to describe the substantial leverage available in futures and options trading, many members use such statements as "A minimum deposit of $2,500 controls $40,000 worth of gold." Such statements, when used in the proper context and fully explained, are useful tools in providing examples of the leverage available; however, if improperly used, these statements might be likely to deceive (in potential violation of Rule 2-29). Use of the term *control* in a manner that implies that the client will own or hold the underlying commodity is misleading. A special concern with options arises if control of the commodity is used to imply that the owner will benefit in full from the price movement of the commodity. Because the price of the option contract might not move in the same amount as the underlying futures contract, it might be considered misleading to use *control* in this context.

Potential Pitfalls with Options

APs should beware of the claim, "Options have limited risk and no margin calls." Many members are heavily involved in the exchange-traded option markets. A key component in the promotion of these instruments is the contrast between options and futures. While such an approach is acceptable, you should provide full information to the potential client. Statements that options have limited risk and no margin calls might omit facts that make the material misleading (in potential violation of Rule 2-29). All options do not have limited risk, and only certain options do not have margin calls. (Also, a person who has an options position might find

himself or herself with a futures position if the option is exercised.) The only time that options have these characteristics is when the trader has long (rather than short) positions. Short options, in fact, expose their holders to risks in excess of their initial investment and to margin calls. Thus, to make such claims about exchange-traded options, a member should make it clear that these characteristics only apply to long option positions (and that a long option can be exercised if it is not offset prior to expiration). Also related to this subject is the concept of limited risk. To simply state that the risk of a long option is limited or predetermined without making it clear that the limit is the full amount of the investment is likely to deceive the public and will be treated as a potential violation of Rule 2-29. Similarly, limited risk might imply that the likelihood of loss, rather than the magnitude, is somehow limited. A full description of the limited nature of the risk is unnecessary.

Who Is Responsible for Promotional Material Produced by Others?

In applying all NFA requirements, NFA-member Business Conduct committees have always recognized the legal principle of vicarious liability—that each member is responsible for the acts of its agents. This statement certainly applies to the preparation of advertising material. If, for example, a member uses an advertising agency or consulting firm to prepare and distribute promotional material on his or her behalf, the member will be responsible for compliance with Rule 2-29 in the material used by his or her agents. Members cannot avoid responsibility for the material of others by claiming to be unaware of its content or appearance. The failure to review material produced by the agent indicates, in addition to responsibility for deficiencies in the material itself, that the supervisory procedures required in Rule 2-29 were clearly not followed. This same rationale also applies where the agent who prepared the promotional material is another member of the NFA. Of course, we are not saying that a member would be held responsible for material produced by another member of which the member was wholly unaware and that the member had not implicitly or explicitly authorized. Use of another member's name in such material, without authorization or consent, would subject the producing member to problems greater than the limits of Rule 2-29. Finally, a member who produces promotional material for another member might be held liable for any misinformation supplied by that other member if he or she knew that it was false. For example, a member relying on information supplied by a CTA concerning the CTA's performance should at least compare it with the CTA's disclosure document.

Do Training Materials Come under Rule 2-29?

The answer to this question is "Most definitely." A competent, knowledgeable sales force is important to any promotional campaign. NFA members use many methods to train their APs in both industry issues and sales

techniques. One method used by some members is a script or outline of a conversation with a client. These scripts generally provide a variety of alternate approaches for their APs, depending on the responses of the clients. While the use of these scripts is not prohibited, care must be taken to ensure that they comply with all of the requirements of Rule 2-29. The claim that these scripts are "for training purposes only" will not relieve a member of its responsibility for content under Rule 2-29. Rule 2-29(d) requires a member to adopt supervisory procedures over his or her communications with the public and promotional material. A script that trains APs with inaccurate, misleading, or inappropriate information or teaches a high-pressure approach to selling will not satisfy the supervisory requirements of Rule 2-29.

Does the NFA's Rule 2-29 Also Cover Interviews and Live Broadcasts?

Again, the answer to this question is "It sure does." NFA members or associates are occasionally asked to appear on financially oriented television or radio programs. They can discuss, either by themselves or in an interview, general market activities and perhaps their own trading strategies and recommendations. These types of appearances will usually only be subject to the general prohibitions—fraud, high-pressure, appropriateness of futures trading for everyone—of Rule 2-29, because they would not fall within the definition of promotional materials. There is a point at which these appearances cross into the realm of promotional material and therefore would be subject to the more specific requirements of Rule 2-29. Clearly, if the member pays for the appearance, as opposed to appearing on an independently produced program, the appearance would be considered promotional material and would be evaluated accordingly. Also, if the intent of the appearance is clearly intended to solicit new accounts for the member, it will also be considered promotional material. For example, a member buys a daily, one-minute radio spot containing general market commentary—but this commentary concludes with an appeal to call the member for information about how to open an account. Such a spot would fall within the definition of promotional material. Similarly, an appearance in an independent interview, during which a member repeatedly emphasizes his or her performance and promotes the services that are available, is subject to the provisions of Rule 2-29. Finally, a paid promotional appearance of a member, who is not identified as such, will be dealt with as an attempt to deceive the public (and perhaps even as fraud). This type of advertisement generally has the appearance of an independently produced show, which purports to investigate certain investment opportunities. The member is presented as an expert who has been selected by the producer or the interviewer. In actuality, the entire program has been prepared in advance, including the supposedly spontaneous questions and reactions. At the end of the piece, you see a brief disclaimer hear someone explaining that the program was an advertisement paid for by the member. If a member uses such an advertisement, he or she

must make it clear that the advertisement is paid and that all persons appearing have been paid by the member. The member also must indicate that he or she has prepared questions, answers, and opinions in advance. This information must be presented immediately prior to and subsequent to the advertisement—and during the advertisement if necessary—in order to prevent possible deception.

Monitoring Communications and Promotional Material to the Public

Rule 2-29 requires members to adopt and enforce written procedures that enable them to effectively supervise their promotional material and communications with the public. These procedures should cover all aspects of promotional communications, from development and preparation to review and use. The procedures should also address the subjects of promotional material used by its employees and promotional material prepared by other members for their benefit. Both of these types of material must be subject to review by the member. Rule 2-29 requires that at a minimum, the written procedures call for prior review and approval by an appropriate supervisory employee of all promotional material. This review must be documented in writing. Rule 2-29 requires all promotional material, along with the record of its review, to be kept on file by the member. This material must be readily accessible for three years from the date of its last use, and as with other required records, it must be maintained for at least five years altogether.

Can a Member Submit Information to the NFA for Approval?

NFA staff has adopted a pilot program for the review of promotional material prior to its first use. This program is voluntary, and no member can file promotional material with the NFA unless otherwise required to do so by rule or directive. In addition, the adoption of this pilot program in no way lessens the requirements for members to supervise the preparation of and review all promotional material. Members cannot attempt to use NFA staff reviews as a substitute for their own. Members who wish to avail themselves of this pilot program might submit promotional material to the Compliance Department at least 21 days prior to its first intended use. This material should be directed to: National Futures Association, Compliance Department, Promotional Material Group, Suite 1500, 200 W. Madison St., Chicago, IL 60606. In addition, members can ask general questions about promotional material of Compliance Rule 2-29 by contacting NFA's Informational Center at (312) 781-1410. Such inquiries will be forwarded to the appropriate personnel for response. Submitted material must be accompanied by a cover letter and signed by a supervisory employee who is responsible for the review and approval of the member's promotional material. NFA staff will not pre-review material received directly form APs. NFA staff will review submissions as

expeditiously as possible. If additional information is needed, or if the review cannot be completed within the 21-day period, then the member will be so notified. (We anticipate that only in highly unusual circumstances would the review take more than 21 days.) At the conclusion of the review, the comments of NFA staff will be conveyed to the member (generally by telephone). Obviously, NFA staff will not be able to independently verify the accuracy of the material within the 21-day review period; rather, that responsibility remains with the member. Therefore, submitting promotional material to NFA will not provide a safe harbor for members if misstatements or omissions of material facts are discovered subsequently. The NFA staff review, however, will provide valuable guidance to members—particularly with regard to areas such as balance and the proper use of disclaimers. NFA staff anticipates that this pilot program will become a permanent service to its members and that the program will assist members with their efforts to ensure that promotional material complies with NFA rules.

NFA RULE 2-29

Communication with the Public and Promotional Material

A. General Prohibition

No Member or Associate shall make any communication with the public which:

1. operates as fraud or deceit; or
2. employs or is part of a high-pressure approach; or
3. makes any statement that futures trading is appropriate for all persons

B. Content of Promotional Material

No Member or Associate shall use any promotional material which:

1. is likely to deceive the public; or
2. contains any material misstatement of fact, or which the Member or Associate knowingly omits a fact if the omission makes the promotional material misleading; or
3. mentions the possibility of profit unless accompanied by an equally prominent statement of the risk of loss; or
4. includes a measurement or description of, or makes any reference to, hypothetical results which could have been employed in the past, unless accompanied by the statement prescribed in CFTC Regulation 4.41(b)(1); or
5. includes any reference to actual past trading profits without mentioning that past results are not necessarily indicative of future results; or

6. includes any specific numerical or statistical information about past performance of any actual accounts (including rate of return), unless such information is, and can be demonstrated to NFA to be, representative of the actual performance for the same time period of all reasonably comparable accounts and, in the case of rate of return figures, unless such figures are calculated in a manner consistent with that required under CFTC Regulation 4.21(a)(4)(ii)(F).

C. Statements of Opinion

Statements of opinion included in promotional material must be clearly identifiable as such, and must have a reasonable basis in fact.

D. Written Supervisory Procedures

Every member shall adopt and enforce written procedures to supervise its associates and employees for compliance with this rule. Such procedures shall require prior review and approval of all promotional material by an officer, general partner, sole proprietor, branch office manager, or other supervisory employee other than the individual who prepared such material (unless such material was prepared by the only individual qualified to review and approve such material).

E. Record-Keeping

Copies of all promotional material, along with a record of the review and approval required under paragraph (d) of this rule, must be maintained by each member, and be available for examination for a period of three years from the date of the last use. Each member who uses promotional material of the type described in subsection (b) (4) of this rule shall demonstrate the basis for any hypothetical results to NFA upon request.

F. Filing with NFA

The Compliance Director may require any member for any specified period to file copies of all promotional material with NFA promptly after its first use.

G. Definition

For purpose of this rule, "promotional material" includes:

1. Any text of a standardized oral presentation, or any communication for publication in any newspaper, magazine, or similar medium, or for broadcast over television, radio, or other electronic medium, which is disseminated or directed to the public concerning a futures account, agreement, or transaction;
2. any standardized form of report, letter, circular, memorandum, or publication which is disseminated or directed to the public; and
3. any other written material disseminated or directed to the public for the purpose of soliciting a futures account, agreement, or transaction.

In Addition

NFA Compliance Rule 2-29, which deals with the content of promotional material and other communications with the public, is a product of responsive and effective self-regulation. The impetus for its development originated with NFA advisory committees consisting entirely of NFA members. The rule itself was drafted and approved by members. On an ongoing basis, it was interpreted and implemented by NFA member *Business Conduct Committees* (BCCs). All of these members—those who drafted Rule 2-29, those who approved it, and those who implement it on an ongoing basis—recognize two important facts. First, the NFA must have tough regulations to ensure that members observe the highest ethical standards when communicating with the public. Second, no NFA rule should stifle the development and use of fair and effective marketing tools, especially in today's competitive marketplace. Those two facts provide the foundation for the rule itself and for every BCC decision interpreting the rule. Some of its provisions are specific, while others (out of necessity) are more general. Because some of the rule's provisions are stated in general terms, members might understandably seek more specific guidance on some points. The best source for that guidance can be found in the decisions that NFA's BCCs have made in specific disciplinary cases. Since 1986, NFA's BCCs have applied the standards of NFA Compliance Rule 2-29 to the promotional material used by NFA members. In that time, certain recurring questions or issues have occasionally come up, and the BCCs have consistently handled them. The purpose of this material is to provide NFA members with additional guidance for preparing their promotional materials by summarizing how NFA's BCCs have applied Rule 2-29 to those recurring fact patterns.

What to Look for in Brokerage Firms. When it comes to trading futures, there are a number of different trading services from which to choose. There are full-service firms, discount houses, and online trading companies. Many firms will offer the entire line of options in order to appeal to a wider group of traders.

When selecting a brokerage firm as a client or as a broker, you should keep several factors in mind: 1) financial stability (balance sheet); 2) reputation of the firm; 3) order execution; 4) research materials; 5) professional broker; 6) rates; 7) fees; and 8) hours available.

Financial Stability. People consider futures trading for one reason: to make money. They want to be sure that they can collect their money if they have profits. They do not want the additional risk of an account executive running off with their account or the brokerage firm folding. Futures trading is risky enough.

All representatives in the futures industry should address these concerns. Although the client might not ask about these subjects, it is always a good idea to include the following points during an initial conversation about the firm:

1. How long you have been in business
2. The company's capitalization
3. The company's annual sales
4. The net worth of the firm
5. The firm's financial statement or annual report (if requested)
6. If your firm is a clearing member, address the value of this fact. Discuss how the financial integrity of every clearing member is backed by every other clearing member. Explain how a clearinghouse works. Discuss how every trade is marked to the market at the close of every day. Explain how each member firm must have adequate capital at the start of each trading day. Explain that all client funds are kept in segregated accounts and cannot be used to cover the debts of the firm.

Reputation. Reputation is tied to financial soundness, but it also includes the ethical practices of the firm. Every trader should know about the NFA. In fact, you can recommend to a prospect that he or she should contact the NFA directly to check on the registration status of yourself and your firm. On file with the NFA and CFTC are the records of any and all arbitrations and accusations brought against an individual and a member firm. As an industry professional, you should familiarize yourself with that record. Contact the NFA and request a list of any and all reparations brought against your firm and against any of your superiors. You should understand the cases and the outcomes.

Futures trading and brokerage is a business. When you run a business that handles thousands of customers and millions of dollars, complaints are bound to arise. Just as there are many satisfied customers, there will also be those who are dissatisfied with the service they received. Just because a firm has several reparations on file, therefore, does not immediately negate the integrity of the firm.

Look into the nature of the complaints. Are there several complaints of the same type? Do the complaints include fraud in sales practice or advertising? How strong is the language? What was the outcome of the case? Was the case dismissed? This knowledge is extremely important, because sometimes traders who have lost money will do anything to try to get it back (rather than accept responsibility for their own decisions). Many times, you will find hefty lawsuits brought against individual brokers or firms with strong claims. If the case was dismissed, chances are that after reviewing the evidence, the NFA found no fault on part of the broker.

A perfect example is a situation where a trader lets trading losses go too far (the client was unavailable or was simply ignoring the margin calls made by the broker). Finally, the broker has no choice but to liquidate the positions before (or even after) the account runs a deficit.

Often, over a period of time (days, weeks, or even hours), the market will regain its previous losses and return to what would have been profitable levels for the client. The client will then claim that the broker liquidated trades without authority and will demand to be compensated. This situation happens often, and in every case, if the broker has behaved

diligently, kept a record of attempted communication, and acted in a professional manner, the case will be dismissed.

You must examine the details of accusations, therefore, because complaints are merely a part of running a business. Brokers should be prepared to explain the details of such accusations to anyone who inquires.

Order Execution. In what manner does your firm execute trades? This consideration is important, because if it takes too long for an order to be executed, it could make dramatic differences in a trader's profitability.

There are different classifications of order routing within a brokerage firm. We list them as follows, from slowest to fastest:

1. *Small brokerage firm, many brokers, only one desk available to enter orders (the only taped phone lines available).* The broker takes an order from a client, confirms the order on a taped line, and then either the broker or a clerk calls the clearinghouse wire room. The wire room takes the order and then calls the trading floor to place the order. The trading floor gets the order, fills it, and reports it to the wire room. The wire room then contacts the desk at the brokerage firm. The broker confirms the fill with the client.

2. *Medium-size brokerage firm, one order desk.* All lines are taped at the firm, as well as at the trading line. There is no need to confirm the order with a client on a second line. The broker takes the order and gives it to a trading desk. The desk either calls the floor directly, enters the order electronically, or contacts the wire house if needed. All fills are reported to the order desk and then given to the broker. The broker contacts the client.

3. *Large brokerage firm, many brokers, large trading desk area.* All lines are recorded. Brokers or trading desks take orders from clients. Trading desks and brokers give the order to one of many clerks. (Often, there will be one or more clerk per exchange.) The clerk places the order directly with the floor or enters the order electronically. Fills are reported faster, because there are more open lines to the many—and each clerk has fewer orders and trading pits to handle.

4. One option for both Number 2 and Number 3 is that the broker can contact the floor directly. A trader phones in a trade to a broker, and the broker calls straight to the floor (saves one step). The floor reports the fill to the broker immediately (flash fills), and the broker gives the fill to the client.

5. *Online brokers, not direct to floor.* Many firms advertise online trading, but sometimes the order flow is not any faster than if the client called. Many times, the order will first stop at a margin desk, where the account is checked for available margin before heading to the floor. This step can slow the process. Inquire about the flow of orders. Margin checks are difficult to avoid unless the account is well capitalized and the client is experienced.

6. *Orders go directly to the trading pit.* This process can be conducted in several ways. The client might qualify for direct floor access and be able

to call straight to the floor. (Some firms advertise this feature but require a trader to go through a trial period before being granted permission to go direct. Many traders think that they are calling the floor, when in fact they are calling an order room.) Orders can enter the pit via telephone or electronically. Electronic orders can either pop up on a printer inside a pit or on an electronic device that the floor broker holds. Either way, the order is filled and reported quickly.

You should understand the value of each type of order-entry service, depending on your experience. Many firms offer more than one service to meet the needs of the developing trader.

Research. What kind of research does the firm provide? Does the firm have a centralized research department, or do independent brokers do the research? Most traders would like their full-service broker to know more about what is happening in a market than they do. This aspect is the value-added aspect of working with a broker. The broker should provide some sort of advantage with respect to trading. Some clients are not interested in outside research. They do their own work and do not want to be dissuaded by someone else's opinions. Some clients would just like help with order entry and other bits of helpful information.

Clients do expect their brokers to know the basics:

1. Where every futures contract is traded
2. Time trading starts and finishes
3. Margin requirements
4. Order-entry procedures
5. Contract specifications
6. Account paperwork and what it means
7. How to read and understand your statement
8. Industry information
9. Option calculations
10. How to execute an order properly
11. How to get out of a limit situation
12. Which markets are appropriate to trade
13. When reports will be released
14. The impact that reports will have on the market

Broker Relationship. Your relationship with your broker is absolutely paramount to success as a trader. There must be a level of understanding or compatibility between the client and the broker, and the broker must have the client's needs in mind. A broker relationship is not much different than a friendship. The trader and broker must "click." The client must have respect for the broker—not only for his or her integrity, but also for his or her dedication to knowledge and professionalism. They do not have to be best friends, because that might distort business dealings—but there should be some sort of rapport.

Sometimes, this relationship does not happen for traders when they open their first account, and that can lead to a bad experience. Brokers should also notice when there is not a connection with a client. If this situation occurs, the broker or client can just announce that they will be looking elsewhere. Brokers need to remember that it is acceptable to turn away business. In fact, it will always be better in the long run for both parties (if a relationship is strained from the get go) for both parties to go their separate ways. Brokers have the right to refuse business, just as clients have the right to choose their broker. Just because someone wants to open an account with you does not mean that you have to accept it for any reason.

Experience will tell you over time the type of trader or broker with whom you are compatible. Sometimes, the learning process is a rough road. Just remember that you never have to work with someone who makes you feel uncomfortable.

Rates. As the world has changed and the Internet has increased access to worldwide information, the brokerage industry has become more competitive. As a result, commission charges have fallen dramatically. Brokers who used to charge $200 per round-turn are now faced with the necessity to offer many levels of service, from $100 down to $25. As the saying goes, "You get what you pay for." Brokers have designed different levels of services to reflect the varying needs of clientèle. Many brokers offer the more expensive full-service level for the novice trader, a broker-assist level for the more experienced trader (that still requires special order attention), and discount trading for the more active and experienced traders.

Deep discount firms are also available, and rates can be as low as $16 (although a trader has to consider execution speed as part of the decision process). Very inexperienced traders should consider some level of assistance to lower the odds of making too many beginner errors.

Surprisingly, many new traders still do not inquire about commission charges. Many of the high-pressure shops prey on the enthusiasm of the markets and sell profit opportunity but do not mention commission. That is usually because their commission charge is extraordinarily high. They might charge a stiff commission or even a percentage of the option premium as a standard fee. These exorbitant fees make it almost impossible for the trader to make money. Many new and starry-eyed traders are often caught by these types of sales schemes.

A colleague of mine once worked for a brokerage house like the one described previously. The house charged $350 in commission per option and 15 percent of the option premium as a fee. Plus, the brokers would recommend options that were far out-of-the-money so that the client could buy as many of them as possible. A $5,000 account would pay more than $3,500 in commission just to place one option group of trades. That meant that the account would have to earn 70 percent return on the investment just to break even—on one trade. Needless to say, the client had little chance of making money. My colleague told me that although he was making a considerable income, he reached a point where he could not face himself in the mirror in the morning because the guilt was so great.

If you have aspirations of a career in the brokerage business, consider the long term. An honest approach, trading discipline, and reasonable commission charges will enable you to grow your book of clients and earn wealth (financial and emotional) over time.

Fees. Fees are a separate issue than commission charges. The fees that a firm tacks onto a commission charge can be extraordinary. Fees come in the form of the following:

1. NFA fees (unavoidable)
2. Clearing and exchange fees (unavoidable)
3. Brokerage fees (negotiable)
4. Low balance fees (often negotiable)
5. Statement fees (often negotiable)
6. Wire fees
7. T-bill charges
8. Canceled or insufficient check fees
9. Delivery charges (usually not applicable)
10. Transfer fee (negotiable)

1. NFA fees are not negotiable. Every participant in the futures industry pays a fee to the regulatory body. These fees typically must be itemized and kept separate from commission charges. The NFA fee goes toward the support of the administration and the benefits that it provides the industry. The fee is usually a matter of pennies.

2. Clearing and exchange fees are also unavoidable. These are fees paid directly to the exchange for the right to trade at that exchange. Exchanges and clearinghouses provide a service that enables traders to participate in the futures industry. These fees can be as high as $1 or $1.50.

3. Brokerage fees. These are one of the highest charges on the statement. The filling broker on the trading floor charges a brokerage fee. These fees vary from exchange to exchange. Some trading pits such as the NYFE have brokerage fees greater than $4 per side. That means $8 per round-turn, and these fees can add up. Sometimes, these fees are itemized separately with different amounts per trade. Some firms charge a flat fee of $3 per side and do not bother listing the varying amounts. Still other firms incorporate the fee into the commission charge so that the fees do not appear as a separate line. You might see advertisements for "$16 flat," which implies that all fees are incorporated into the price.

4. Some firms charge what is called a low balance fee. If a trading account is under $3,000 or $2,500, the firm will charge the account as much as $10 per month. This fee is also called an account maintenance fee. The argument is that a small account is not generating enough interest or commission to justify access to Web sites, research, monthly statements, and so on, so the firm charges extra for the smaller account. This charge is not always fair, because some smaller accounts are actually quite active. This fee is negotiable on a case-by-case basis.

5. Statement fees are another example of a monthly charge. Some firms might use this term as another word for Number 4, but it usually refers to additional statements that are requested by the client. Additional statements can cost up to $3 each.

6. Firms charge a fee for a wire transfer of money from the company. Most banks charge a wire fee, as do most brokerages. This fee can be as high as $25. A fee is charged to send a wire or if a received wire is rejected and sent back to the bank.

7. T-bill fees refer to the charge to put your money into an interest-bearing Treasury bill. Because most futures accounts do not pay interest, many firms offer the capability for clients to put money into interest-bearing T-bills. There is a fee to buy, break, or roll-over the T-bill into the next maturity. T-bills are typically available at the three-month, six-month, and one-year maturities. There are different interest incomes for each product. The longer the term, the more interest paid. T-bills typically can be used toward the margining of the futures account, but a T-bill cannot be used to buy options. Only liquid cash in the account can be used to buy option premiums. There must be liquid cash available in the account at all times. If the liquidating value of the account, sans T-bill, drops below $0, the account generates a cash call. A cash call is different than a margin call in that it simply requires the existing T-bill to be broken or rolled over into a bill of lesser value in order to free up some liquid cash. The account will be charged another fee to do so. T-bill fees can be as high as $45 per transaction, and they are negotiable.

8. Just like a bank, any check that is returned with insufficient funds will generate a charge of around $10.

9. Delivery charges refer to the fee charged by the brokerage firm if a client chooses to make or take delivery on a futures contract. Because only about 2 percent of all traders and hedgers alike do so, the odds are low that this fee could impact the average account.

10. A transfer fee is a fee charged by a firm to transfer your account to another firm. There is no charge to transfer into a firm, but some companies will try to charge you to transfer out. This fee is negotiable. Also negotiable are the commissions that a firm charges you to transfer in your account. The computer automatically charges any new positions on the run a commission charge. Most brokers and salespeople can have that fee waived. (Most firms want to encourage, not discourage you to come to their firm.) This situation is definitely true for long options, but for short options and futures positions, the firm might insist that the fee be charged to justify the risk of the trade. The fee is still negotiable, however.

Per Side. There is a difference between per side and round-turn. Many times, fees are quoted on a per-side basis, which means that the fee is actually charged to get into the trade and to get out of the trade. Some advertisers are clever in hiding this fact.

Hours Available. Many clients need access to the markets 24 hours a day. Even if they are not trading the overnight markets, they might not be

able to call a broker until late at night. Many firms offer 24-hour trading desks, but some dramatically restrict access to their use. One advantage of an Internet account is that you can place orders at any time for trade the following day. This service might be of value to many traders.

Those clients who prefer a full-service broker can (and do) expect the broker to arrive early and to be available throughout the trading day. Many brokers will team up to ensure that their clients will always have access to the markets and to their positions.

Daily Equity Run. Clients need to see their account balance everyday. Many firms now offer an e-mail service that will send a daily summary of account status and open positions at the close of each day. Each trade is marked to the market at the end of the day, so a trader should be able to get his or her account balance to the penny every single day. A large part of honesty with clients is communicating their positions and account balance accurately each day.

Sales Material. Traders want to feel that they are doing business with a substantial company. Solid sales literature will help communicate this fact. A company brochure should include how long the company has been in business, the experience of the people, who the clearing firm is, and a financial statement. The brochure should project an image of honesty, integrity, financial soundness, and knowledgeability.

Managed Accounts. Managed products might be the most important developments in the history of retail futures. Managed funds have the following attributes:

1. Limited liability—With a managed product, the liability can be limited to the amount invested. This situation is true with commodity pools and some limited partnerships offered by brokerage houses but is not necessarily true with individual managed accounts. There are many CTAs who manage individual accounts for a cut of the profit and a small management fee. Each account is kept segregated, and the risk of loss can exceed the value of the account (as with any individual futures account). Commodity pools operate more like mutual funds, where customer funds are merged into one fund. Typically, the risk of loss cannot exceed the amount deposited.

2. Modest investment—With many managed accounts, an investor can participate with as little as $5,000. Some have high minimum balances, however—as much as $150,000.

3. Free time—Managed accounts alleviate the need for the investor to study the markets himself or herself. Just like a mutual fund, the investor defers the trading decisions to an account manager. Commodity funds are a healthy way to diversify a stock portfolio. Typically, commodity funds do well in different environments than the stock market.

4. Lower relative fees—The fees charged in a managed futures account might seem high when compared to those of a mutual fund or other stock product, but compared to the commissions paid in a trading account, they are actually quite low. Commission fees in an individual account, depending on service and activity, can be as high as 30 percent of the account value.

Managed account fees are relatively lower, because professionals can negotiate lower commissions and are often paid partial interest on liquid funds.

a. Sales fees: Sales fees average about 1 percent per year. Sometimes they are paid in advance—as with a front-end load.
b. Brokerage fees: These fees amount to about 5 percent or so of the account size.
c. Management Fees: Managers are paid a management fee of 2 percent to 3 percent per year. They are also paid around 25 percent of the profits generated in the account. These fees are often calculated and distributed quarterly.
d. General partner fees: The general partner is often paid a fee for maintaining the financial integrity of the fund (providing the limited risk guarantee).
e. Administrative fees: These fees consist of accounting, correspondence, and other organizational fees and add up to a small percentage of the account.

The fees on a managed account are still a significant percentage of the account. While less than what the average retail client would normally pay to a broker, a managed account must still earn significant returns in order to cover the costs. Presumably, a professional trader has a better chance of being profitable than the average investor.

5. Registered track record—All CTAs are required to register with the NFA. The NFA keeps an accurate record of the trader's performance record and past disciplinary action if necessary. There are also services available that rank the top-performing CTAs around the world. One such service is called the *Managed Accounts Report* (MAR). You can reach this service at 220 Fifth Ave., New York, NY 10001. *Futures* Magazine will also regularly report the top performing CTAs in its monthly publication.

How to Evaluate CTA Performance. Many publications explain in detail how to evaluate the performance of managed funds. One source that I found to be helpful was a book called *Starting Out in Futures Trading* by Mark J. Powers. In Chapter 3, the author goes into great detail in terms of what to look for in a commodity fund. He gives examples such as 1) compound annual return; 2) largest single losing month; 3) largest loss from peak to valley; 4) how long the largest losing streak lasted; 5) how long it took to recover losses; and 6) Sharpe ratios.

The Sharpe ratio is named after William Sharpe, Nobel Prize winner and professor. Powers says, ". . . measures relative reward and risk by subtracting the monthly average T-bill rate from the monthly average investment return and then dividing by the standard deviation of the monthly returns." The higher the Sharpe ratio, the better the reward/risk ratio.

$$\text{Sharpe Ratio} = \frac{\text{Investment Return} - \text{T-Bill Return}}{\text{Standard Deviation of Investment Return}}$$

Obviously, statistical data calculations do not imply or guarantee that the account will be profitable in the future. These calculations are one manner of evaluating the consistency of past performance in order to obtain an indication of what might happen in the future. There are other means of quantifying account performance as well, and these are listed in our earlier reference.

How to Generate Futures Business

The most important thing that traders want from their broker is honesty. They do not want them to promise profits or even win on every trade; rather, they want the broker to be honest about positions, losses, and risks. The following are ways in which you can generat futures business:

- Seminars
- Internet marketing
- Trading rules

A commodities broker's life has many ups and downs. There is generally one major advantage and one major disadvantage. The advantage is that you operate under 100 percent commission; thus, your income is unlimited. The disadvantage is that you operate under 100 percent commission. As a broker, you are your own boss, and you can set your own hours and take a vacation whenever you want. You also have risk, however, because you are responsible for your own errors. If you take time off, you are responsible for errors made in your absence. If you hire a clerk, you are responsible for his or her errors. If your client goes deficit in his or her account, you potentially are responsible for the difference in the account. You need to ensure that your clients are adequately margined. If you conduct a margin liquidation in their absence, you might be asked to prove in a court of law that your actions were legitimate.

The following list examines what it takes to be a good broker:

1. A good broker is always at work on time.
2. A good broker never leaves his or her phone unattended.
3. A good broker checks out trades every single morning.
4. A good broker margins his or her run throughout the day.
5. A good broker is trustworthy.
6. A good broker takes responsibility for his or her actions.
7. A good broker discloses the true risk involved in a trade.
8. A good broker follows NFA rules.
9. A good broker builds a client relationship based on trust.
10. A good broker does not accept funds from a person who is clearly not suited for commodities trading.
11. A good broker does not allow a client to trade futures on funds that have not been cleared.
12. A good broker does not hide errors.

What it takes to be an excellent broker:

1. An excellent broker is always studying new ways to be a better trader.
2. An excellent broker spends time in the evening chatting with his or her clients.
3. An excellent broker spends time on the weekends making calls or looking for trades.
4. An excellent broker would rather not trade than get into a bad trade.
5. An excellent broker always has the needs of the client ahead of his or her own.
6. An excellent broker remembers family members' names.
7. An excellent broker knows the name of the client's secretary.
8. An excellent broker remembers clients' birthdays.
9. An excellent broker is a good listener.
10. An excellent broker does not recommend for a client to trade with money that he or she cannot afford to lose.
11. An excellent broker cuts off a client when he or she feels that the client is being destructive in his or her trading patterns.

A broker should put the needs of the client before his or her own, particularly with respect to trade suggestions. A broker should not recommend a trade simply because it will generate large commission dollars but because he or she feels that it has good potential to make money. If a client calls and would like to be long soybeans, the broker should suggest a few of-the-money call options at low volatility levels, as opposed to 20 out-of-the-money options at high volatility levels. The client will respect that style and be more likely to stay with a broker for years. On the other hand, brokers are not perfect—nor do they claim to be perfect. And traders should not expect them to be. Trading decisions ultimately lie in the hands of the client. The client has the last word on whether to take a trade, to take a loss, or to take a profit. If the broker has performed in an ethical manner, honors his or her mistakes, and has fully disclosed the risks of trading to the client, the client has no ground to fault the broker for trading losses. Unfortunately, that fact does not stop clients from attempting to manipulate their brokers, verbally assault them, and threaten to sue them.

When you deal with people's money, you have to deal with emotions as well. I can count on one hand the number of times that a disappointed client has threatened me for money, and that is out of almost 1,000 clients over the years. Although it infuriated me at the time, in hindsight it was a waste of energy worrying about it. Things do not always go smoothly in life, and as hard as it is to understand why people behave the way they do, you have to realize that you simply cannot please all of the people all of the time. Errors that you handle quickly are not a threat. When a client demands a return of trading losses, fight it—but do not let it tie you up emotionally. Accept disputes as a part of the business, and continue to conduct your business in the best way you know how.

How to Be a Good Client

Just as a broker needs to be responsible, so does the client. For example, if you choose to invest your money in commodities, you must also understand that there is a certain amount of risk involved. You need to accept responsibility for your decisions. You cannot hold a person liable for trading losses that arise from trades upon which you agreed (or if you allowed the broker to trade for you).

Profile of a Good Client

A good client typically possesses the following traits:

1. Takes responsibility for his or her actions
2. Knows that to err is human
3. Knows that if he or she is not satisfied, he or she can always move the account
4. Knows that the grass is not always greener on the other side of the fence
5. Does not push the account to margin calls
6. Answers margin calls via wire transfer or liquidation the same day
7. Does not lie to the broker
8. Does not write bad checks
9. A good client only trades with risk capital
10. Understands that he or she is not the only client trading with the broker and respects his or her time

Why Traders Change Brokers

Futures brokers are all essentially competitors. Brokers compete for business from the same pool of available investors. Brokers of different firms are competing with each other just as brokers within a brokerage firm are also competing with each other. Many traders cite the same reasons for changing brokers. The following list shows the primary examples of how a broker loses business, as compiled by The Walsh Agency, Inc., at `info@walshagencyinc.com`:

1. The broker pressured for too much trading.
2. There was bad chemistry between the broker and the customer.
3. The broker was unwilling to admit mistakes and rode losers too long. He or she did not use intelligent stops, which in most cases should be entered when the trade is first established.
4. The *Account Executive* (AE) had no discipline, did not stick to a plan, had no patience, and talked clients into or out of trades instead of keeping cool and standing pat.
5. Statements and other records kept by the broker were either inaccurate or misrepresented by the AE.
6. Some clients tell their friends that they are doing well, and the friends switch over to the winning firm.

7. Greed on the part of the broker results in always wanting to trade, trade, trade. Remember, standing aside is a position.
8. Orders were filled or reported too slowly.
9. The broker did not truly understand the client's goals.
10. Unexpectedly high margin calls might shock the client into leaving the broker.
11. A broker tries to fit the client into his program, rather than tailoring the program to the client. This situation is asking for trouble. Each client is different financially and emotionally.
12. A broker who gives lots of contact, help, and advice before opening an account (and not much after) is risking losing clients.
13. If a broker is a novice who makes mistakes with his client's money, the client might look elsewhere.
14. Many clients switch firms if they do not have access to where they stand every day (to the penny).
15. Brokers must be up front with their clients, even if the news is bad. Sometimes the truth hurts, but being honest is always the best policy. Clients expect it.
16. Some brokers do not provide enough service to justify the extra commission.
17. Some clients get bored with their brokers if they do not trade enough. AEs must teach their clients discipline. Traders who are always in search of action are likely to be reckless and lose money.
18. Many clients leave in search of better research and information.
19. Some brokers lose their discipline after a string of winning trades. They promptly lose all of the profits and more.
20. Some clients do not switch completely; instead, they put some of their money with another broker to compare results. This idea is not good, because smaller accounts have a harder time making money.
21. A broker without a game plan might lose clients.
22. Day trading, or scalping the market, is a sure way to lose money and clients.
23. A broker is too aggressive from the get-go and intimidates the client and/or loses the entire account to the market.
24. Some clients are merely drawn away from persistent solicitation by another broker.
25. Some brokers have a directional bias (always short the stock market or long beans), and that might cause clients to leave.
26. A broker must take responsibility for winners and losers. In fact, it is even better to verbally reward the client for taking a winning trade suggestion. Remember, it takes two to tango. The broker must suggest it, and the client must accept it. This statement is true for winners and losers. If the broker tries to minimize his or her contribution to a loss, the client might eventually leave.
27. A broker must be available during market hours.
28. Brokers should give equal time to clients. If a client feels neglected, he or she is likely to leave. Bear in mind that some people demand more than their fair share of attention, and pleasing all of the people all of the time is not possible.
29. A broker should admit when he or she does not know something. This action will avoid allowing a client to make a major mistake.

30. Some clients switch to a larger house for security reasons.
31. Clients might leave if they feel that their broker is indifferent about service or losses.
32. If a broker is too emotional and volatile, a client is likely to leave.
33. Many clients leave in search of different types of service and/or lower rates. A broker can keep business if he or she offers varying degrees of service within the firm.
34. Clients prefer brokers who have strict risk-management plans.

All of these reasons can cause a client to leave his or her broker. Competing brokers will often hit on these points to find a need that the client has that his or her broker is not fulfilling. Stealing an unhappy client from a mediocre broker is easy. The new broker needs to be certain that he or she can follow through on the promises, however, or else the client will move again.

Broker-to-Broker Relationships

Healthy competition is good for the market. This competition keeps brokers honest, keeps fees reasonable, and keeps information available. There is a point where broker-to-broker relationships breach an unwritten code of ethics. As competitive as the marketplace is, a broker will last a lot longer if he or she follows the following code:

1. If a broker receives a call from a trader requesting information, one of the first questions that the broker should ask is, "Are you trading futures currently?" or "Do you already have an account with my firm?"

2. If the client is already trading with a broker within the same firm, the broker should inform the caller that he or she will make certain that the client's current broker will distribute the requested information. Then, the broker should thank the client for calling. The broker should then inform his or her colleague of the contact and the nature of the conversation.

3. If the client has been on a free trial of a broker's service and then announces that he or she is working within the firm, the broker should first suggest for the client to open a second account in order to trade the new method, rather than requesting the client to move his or her existing account away from the broker's colleague.

4. In some cases, a client is unhappy with his or her current broker and would like to switch brokers within the firm. In that case, the client can certainly do so. The protocol is that the transfer of accounts should be done via the manager in order to alleviate any hard feelings. This situation happens periodically, and if handled ethically, most brokers will understand. The primary concern is that the client is happy and stays within the company. Do not involve a client in a competitive struggle. Besides, what comes around goes around. Good deeds are eventually returned.

5. If a broker contacts a prospect who is trading at another firm, the broker should not bash the other firm or individuals—regardless of the firm's reputation. Many clients do not want to admit that they are losing money or are paying too much commission, and they are actually more likely to defend their broker if he or she is attacked. After all, to admit that the client's current broker is bad is a reflection on the client for choosing him or her. Let the prospects tell you what they find wrong about their broker or firm. Ask revealing questions and make note of the problems, then answer those concerns with some of the positive attributes of your firm. Do not tell a prospect that his or her broker is bad or insult the firm that she is with (it will not get you very far in the conversation and is likely to turn the prospective client against you).

6. Avoid prospects who are in disputes with their current broker. Regardless of the circumstances, it is best not to get involved.

7. Know your competitors. Familiarize yourself with every service, research material, and fee charged by competing firms. Know their NFA registration status and the records of their top brokers. These facts can work to your advantage if you know your competitors' pitfalls and how your firm stands against them. For example, if a prospect is trading with ABC firm and you already know that execution at ABC firm is slow, you might be able to ask the prospect a revealing question such as, "How is the speed of execution at ABC?" Of course, you know that the execution is slower than sin, but you let the client tell you that he or she is disappointed with the fill service. Then, you might come back and say, "I have heard that before. Here at XYZ, we get around that problem by offering direct floor access to qualified traders" (or something similar). In this manner, you have revealed a concern of the prospect and a quality of your company without alienating the caller.

8. You might want to invite a prospect to check on the registration status of you and your firm by contacting the NFA. This action is helpful if a) the prospect is disappointed with his or her current broker, b) if your track record is clean, and c) if the track record of your competitor is not clean. You do not need to suggest for the prospect to check on his or her current firm; if he or she calls the NFA to check on you, he or she will automatically check on them as well.

Why Most Futures Traders Lose Money

A survey of more than 500 experienced futures brokers asked what, in their experience, caused most futures traders to lose money. These account executives represent the trading experience of more than 10,000 futures traders. In addition, most of these account executives have also traded or are currently trading for themselves. Their answers are not summarized, because different traders make and lose money for different reasons. Perhaps you might recognize some of your strengths and weaknesses. Yet, many of the reasons given are similar from broker to broker. The repetitions stand to demonstrate that alas, many futures traders lose

money for the same reasons. Perhaps these statements from experienced brokers can make a contribution to you and make this sometimes fickle, often intricate, always interesting marketplace of futures trading possible. Here is what they said:

1. Many futures traders trade without a plan. They do not define specific risk and profit objectives before trading. Even if they establish a plan, they second guess it and do not stick to it—particularly if the trade is a loss. Consequently, they overtrade and use their equity to the limit (trade undercapitalized), which puts them in a squeeze and forces them to liquidate positions. Usually, they liquidate the good trades and keep the bad ones.
2. Many traders do not realize that the news that they hear and read has, in many cases, already been discounted by the market.
3. After several profitable trades, many speculators become wild and speculative with their trades. They base their trades on hunches and long shots, rather than sound fundamental and technical reasoning. Or, put their money into one deal that "cannot fail."
4. Traders often try to carry too big a position with too little capital and trade too frequently for the size of the account.
5. Some traders try to beat the market by day trading, nervous scalping, and becoming greedy.
6. Some traders fail to predefine risk, add to a losing position, and fail to use stops.
7. They frequently have a directional bias. For example, they always want to be long.

   Many traders are trying to catch the next bull move in soybeans or gold and ignore bearish patterns that persist for long stretches of time.

   Lack of experience in the market causes many traders to become emotionally and/or financially committed to one trade and unwilling or unable to take a loss. They might be unable to admit that they have made a mistake, or they look at the market on too short a lifetime. A trader might be unable to take a loss if the market locks limit against the position.

   Many traders ignore the major trend. Markets move in trends of varying periods. There are many intermediate and shorter-term trends within a longer-term move. Recognizing the most powerful trend will help keep the trader on the right side of the market.
8. They overtrade.
9. Many traders cannot (or do not) take the small losses. They often stick with a loser until it really hurts, then they take the loss.
10. Many traders get a fundamental case and hang onto it, even after the market technically turns. They only believe fundamentals as long as the technical signals follow. Both must agree.
11. Many traders break the cardinal rule, "Cut losses short. Let profits run."
12. Many people trade with their hearts instead of with their heads. For some traders, adversity (or success) distorts judgment. That is why they need a plan at first.

13. Often, traders have bad timing and not enough capital to survive the shakeout.
14. Too many traders perceive futures markets as an intuitive arena. They have an inability to distinguish between price fluctuations that reflect the fundamental change and those that represent an interim change (often causing losses).
15. Many traders do not define offensive and defensive plans when they take an initial position.
16. Emotion causes traders to hold on to losers for too long.
17. Too many traders are underfinanced and get washed out at the extremes (over-leveraged).
18. Greed causes some traders to allow profits to dwindle into losses while hoping for larger profits. Also, over-trading and being in too many markets at once can result from greed.
19. Trying to trade inactive markets is dangerous.
20. Taking too big of a risk versus too little profit potential is a sure way to lose.
21. Many traders lose because they do not take losses that are in appropriate proportion to their account size.
22. Often traders do not recognize the difference between trading markets and trending markets.
23. Lack of discipline includes impatience, the need for action, forcing market direction, and so on.
24. Trading against the trend (especially without reasonable stops), trading undercapitalized, and improper money management are major causes of losses. A large account does not guarantee success.
25. Over-trading stems results from a lack of planning.
26. Trading in speculative commodities is often a mistake.
27. Some traders have an inability to stick with winners.
28. Some traders refuse to take advice from another person (such as their broker or an experienced trader (particularly in reference to taking a profit or minimizing a loss).
29. Traders cut winners short and let losers run. This situation adds up to a losing strategy over the long run.
30. Traders are compelled to trade every rumor.
31. Traders use their gut feelings to their detriment.
32. Traders should use genuine risk capital in the market to avoid emotional attachment to the money at hand.
33. Losing traders often try to pick tops or bottoms and do not wait for the market to show signs of a turnaround.
34. Without a plan, the result is emotional trading.
35. Frequently, traders judge markets on the local situation only, rather than taking the worldwide situation into account.
36. A good plan must include defense points.
37. Some traders do not believe price action. They insist that the market cannot possibly be moving that way.
38. Many traders trade only one commodity (and some trade too many).
39. Trading against the trend can lead to losses.
40. Jumping into a market based on the morning news—which has often already discounted the information—is dangerous. By the time the news hits the general media, the trade is usually over.

41. Self-discipline is required for brokers as well as for traders.
42. Losing traders do not stick to risk parameters.
43. Traders do not do enough research and trade on whims.
44. Most traders are undercapitalized.
45. Some traders trade based on misguided information.

This information is available in a handout form from the Center for Futures Education (www.futuresethicstraining.com) or from John Walsh and Associates (info@walshagencyinc.com).

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About the Author

Donna Kline was raised in San Diego, California. She graduated from U.C. Davis with a degree in Genetics. She then went on to earn her MBA from Santa Clara University with an emphasis in Agricultural Business. While earning her MBA degree, Donna served as the Teachers Assistant for a commodities and hedging course. This is where she fell in love with the markets. Shortly after graduation, she moved to Chicago to begin her career as a futures and options broker.

After several years of studying and working hard, Donna developed a solid client base and nationwide recognition. She has published several articles on trading and has delivered seminars all across the country.

Donna began working in television as an expert on local station WCIU in Chicago and eventually went on to be a market guest for CNBC, CNN*fn*, and various other radio and television networks.

Ultimately, Donna recognized her skills as a television personality and went on to pursue that goal.

Donna Kline is currently working as a broadcaster for Bloomberg Television in New York City.

She still loves the markets.